85th Congress
2d Session

COMMITTEE PRINT

U.S. Congress. Senate

INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES

4 OCT 30
Copy 1958

COMMENTS OF ECONOMISTS, PROFESSORS, AND OTHERS IN RESPONSE TO THE QUESTIONNAIRE

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

EIGHTY-FIFTH CONGRESS

SECOND SESSION

CHAPTER 6

Printed for the use of the Committee on Finance

UNITED STATES
GOVERNMENT PRINTING OFFICE
WASHINGTON : 1958

28420

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UNIVERSITY OF NORTH CAROLINA,
SCHOOL OF BUSINESS ADMINISTRATION,
Chapel Hill, N. C., April 8, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: In response to your request of February 17 I have prepared answers to the series of questions you have raised in connection with the inquiry of the Finance Committee entitled "Investigation of the Financial Condition of the United States."

This 38-page response to your inquiry is, of necessity, an abbreviated treatment of the several questions you raised. You and the members of the committee staff are to be congratulated for the penetrating quality and appropriateness of the questions you have raised. They are the right questions and your committee is performing a real public service by asking them.

I shall, of course, be happy to appear before the committee in further elaboration of my statement if that should be your subsequent wish. If you need additional copies of the statement, please let me know.

Very truly yours,

MAURICE W. LEE, *Dean.*

Attachment.

INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES

By Maurice W. Lee, Dean, School of Business Administration, University of North Carolina, Chapel Hill, N. C.

1. Give a definition of deflation and inflation.

The simplest statement is also the most useful. Deflation involves a decline in prices—inflation an increase in prices. The matter of defining these terms may, of course, be made much more complex. What of the case when consumer prices are rising and wholesale prices are declining? Here there are broad inflationary and deflationary trends coexistent in the economy. If it is assumed that the ultimate objective of an economy is to place a maximum amount of goods and services in the hands of final consumers then the more significant measure of inflation and deflation is the price index of final consumer purchases. With this in mind the mixed trend cited above would be characterized as inflationary.

Although the matter of defining deflation and inflation may be complicated endlessly the most useful concept remains, as suggested, the simplest. Deflation is a condition of falling prices. Inflation is present when the value of money is falling and the prices of goods and services is rising.

2. How can the economy of the United States best avoid either inflation or deflation? Should present laws be changed or new laws enacted?

Stated simply price level movements are the product of disparities between the flow of money into the market and the flow of goods and services. An expansion of the effective money flow, if not accompanied by a corresponding expansion in the flow of goods and services will lead to an upward movement of prices. Conversely an expansion in the flow of goods and services not matched by a corresponding increase in the effective money stream will lead to falling prices. The avoidance of either inflation or deflation requires that there be a continuing balance between the money supply and the supply of goods and services.

In our mature western economies goods and services are exchanged for money and money is then used to purchase other goods and services. We rely upon the profit system to provide the stimulus for maximizing the output of goods and services. We rely upon the banking system to provide appropriate expansions and contractions in the money flow commensurate with the flow of goods and services. We assign to the Federal Reserve System responsibility for supervising the operations of our banking system, for controlling the flow of credit through the economy. And Government through its tax and expenditure programs can draw money out of the economy or push money into it.

The ultimate responsibility for avoiding either inflation or deflation must rest with the Federal Reserve System and the Treasury. Today it appears that economic thought in this country has progressed from a strong conviction that the economy should be left to run its own course to a general and nonpartisan acceptance of the need for a stabilization policy which will prevent excessive fluctuations in the private economy. Both inflation and deflation must be contained. However, this does not mean that the economy should be held at some fixed static level. Some degree of economic fluctuation is essential.

In a free-enterprise economy progress and economic fluctuations are associated. New ventures are launched, grow and develop. Others, unable to meet the standards of the competitive system fail and disappear from the economic scene. The evolutionary processes of economic growth and development flourish in an atmosphere of freedom and moderate ebb and flow. Also, however, they may be destroyed if these economic fluctuations become too violent. This, then, is the essential problem of economic stabilization—to develop a program which will avoid excessive economic fluctuations while, at the same time, permitting the more moderate movements which are essential to the ongoing of a healthy, expanding economic system.

From this certain general principles emerge as guideposts for a program of economic stabilization. Such a program should meet the following tests:

1. Limit excessive economic fluctuations but not interfere with appropriate fluctuations which are required for sustained long-run economic growth.
2. Avoid, so far as possible, interference with the operation of the free market. Only where free-market forces give indication of producing continuing excessive deflationary or inflationary results will a program of economic stabilization be invoked.
3. Whenever possible, in choosing among different stabilization devices those which least interfere with the detailed operation of the free-market mechanism will be given preference.

4. Maintain a due regard, in the evolution of the stabilization program, for the dangers of producing excessive fluctuations in the economic systems of other nations.

The machinery of economic stabilization is now generally understood. It consists of monetary, fiscal, and debt policy—all indirect forms of control—and a panoply of direct controls. Among these latter which have either been widely used or widely considered for use are direct credit controls, price, wage, and rent ceilings—all aimed at the excesses of an inflationary situation—or agricultural price supports, deposit insurance, portions of social security and mortgage credit legislation—all relevant to periods of threatening deflation. Since subsequent questions of the committee call for detailed consideration of these matters only a brief summary comment about each will be presented at this point.

In terms of the four yardsticks noted above it is clear that direct controls such as price or wage ceilings should be regarded as weapons of last resort in the fight for economic stability. Controls of this sort involve a serious interference with the detailed operation of the free-market system. Once inaugurated they invite and, in fact, almost compel the adoption of other direct interferences with the free economy such as rationing of consumer goods and materials allocation programs for producer goods.

Principal reliance must be placed upon the direct tools of economic stabilization—upon monetary, fiscal and debt policy. These are general controls in the sense that they affect the total money flow available for the purchase of goods and services and allow the competitive system to continue its function of allocating economic effort and economic rewards.

Monetary policy is the most flexible of these general controls. It operates through variations in the discount rate, through open-market purchases and sales and through alterations in the reserve ratios required of member banks. It attempts to relate the total effective money flow to the flow of goods and services produced for sale in the economy. By seeking a balance between money and goods (and services) price stability is maintained. If the economy appears to be expanding too rapidly the Federal Reserve System can raise the discount rate thereby increasing the cost of member bank borrowing and thus dampening the expansion in credit money. In support of this rate action it may also sell some of its holdings of Government issues on the open market, thus additionally mopping up a portion of the purchasing power of the economy. It may, in addition, raise the reserve rates required of member banks thus reducing the amount of credit such banks can issue. These different tools of monetary policy will be closely coordinated.

Monetary policy has the great virtue of flexibility. It may be varied from moment to moment. But it is more effective in periods of threatening inflation than it is when an economic decline is underway. In times of deflation about all that monetary policy can do is make certain that there are funds available—it cannot compel that they be spent.

Fiscal policy, which may be subdivided into expenditure policy and tax policy, is much less flexible, much less quick on its feet than monetary policy. If Government spending is increased, more money will be pushed into the economy. If it is reduced, less money flows out into

private hands. But changes in the rate of Government spending are not ordinarily made on short notice. A whole apparatus of executive and legislative decisionmaking must ordinarily be brought into operation before such a change can be realized.

On the tax side of fiscal policy much the same thing may be said. Changes in the tax rate structure may only be accomplished after decisions have been made in the executive branch and deliberations have been undertaken in the legislative branch of the Government. Tax rates appropriate to an economic expansion may thus be continued with full deflationary impact many months into a period of recession. Or, conversely, a low tax rate structure may be prolonged into a period of expansion thus aggravating the inflationary pressures of such a period.

Government deficits and surpluses have great impact upon the national economy and could be a vital force for economic stabilization. Too often in the past fiscal impacts have been counterstabilizing in their effect. This is perhaps not surprising since Government expenditure programs and tax programs are undertaken with an eye to many things other than economic stabilization. But if governmental fiscal impacts are to contribute to economic stability rather than instability more attention will have to be paid to the stabilization consequences of fiscal policy than has been the case heretofore. More will be said of this in the detailed evaluation of fiscal policy below.

Debt policy which involves questions of type, interest rates, and maturity distribution of Government issues should be closely related to matters of economic stabilization. Such has not been the case on many occasions in the past. The Treasury has generally been under pressure or has thought it was under pressure to minimize the cost of servicing the debt. This it could most conspicuously do by seeking the lowest possible interest rate upon its issues and by weighting the maturity spread of the debt heavily into the low interest bearing categories. This has caused the Treasury to become committed to a low interest rate as though that were the primary objective of debt policy. The tendency to ignore or place only minor emphasis upon the stabilization consequences of debt policy has, in the past, and particularly in the period preceding the accord, placed the Treasury in opposition to the Federal Reserve System—placed the Treasury in a position of stimulating inflation in times of inflation.

In conclusion at this point, experience with stabilization efforts up to the present time suggests that monetary policy is more effective in curbing an inflationary development than it is in coping with problems of deflation. And in practice most of the burden of dealing with inflation has been placed upon the monetary authorities. Fiscal policy, where it has not been a positive destabilizing force, has proved slow and ponderous in stabilization affairs. New legislation, by means of which the Congress might set basic tax rates but allow the executive branch to move the effective rates up or down within a moderate range could add to the flexibility of fiscal policy and produce a greater awareness of stabilization responsibilities among fiscal authorities.

Although caution is urged before resorting to direct controls one possible line of exception may be found in the case of direct credit controls. There is a great deal more to be said for such controls than

for most of the direct types of regulation. If the monetary authorities were given power to vary the downpayments, interest rates, and length of payment periods on consumer and real estate credit this would be only a moderate intrusion upon the private economy and would still be in part a quasi-indirect form of control.

3. You have asked for an evaluation of the monetary policies of the Federal Reserve System in the period 1942 to the present.

During the war and early postwar years the primary job assigned to the monetary authorities was that of providing an orderly market for the large quantity of Government securities then outstanding. The decision had been made earlier to finance the war on as low an interest rate basis as possible. Once that decision was made there was little the Federal Reserve System could do except provide a plentiful supply of funds for the economy to use in purchasing Government issues bearing low rates of interest. Open-market policies were determined for Reserve officers by the requirement that they maintain a market for Government issues. Variations in the discount rate were not allowed since that rate had to be kept frozen in relation to the yield rate on governments. Thus monetary policy was made outside the Reserve System during this period and became, at best, a passive supporter of inflation. The impossible (under these conditions) task of preventing inflation was assigned to the direct wartime controls.

The year 1946 was a benchmark year in many ways. It marked the adoption of the so-called Full Employment Act. It also saw the termination of most of the direct wartime controls. The 1941–46 increase in money supply, held in check temporarily by direct controls, now burst upon the market as these restrictions were withdrawn. Wholesale prices jumped by more than 50 percent and consumer prices rose by more than a third between 1945 and 1948.

The tangled skein of Treasury-Federal Reserve relations continued in the postwar years. As early as 1945 the Federal Reserve System had expressed concern to the Treasury over the continuance of the preferential rate of 0.5 percent and suggested that both it and the fixed rate on Treasury bills be abolished so that an effective monetary policy might be devised. In the spring of 1946 the Federal Reserve System discontinued the preferential rate but agreed, in line with Treasury insistence, to continue its general support of the Government issues market. In the absence of restraining monetary policy the inflation continued.

In July 1947, following prolonged Treasury-Federal Reserve discussion, the rate on 1-year Treasury certificates was moved from seven-eighths of 1 percent to 1¼ percent, but the Federal Reserve was still committed to the support of Government securities. In June of 1950, with the outbreak of the Korean war, the Federal Reserve System argued that the renewed inflationary pressures which lay ahead made further inaction on the monetary front intolerable. The Treasury, confronted by prospects of material deficit financing, insisted that the Federal Reserve System continue to support Government issues at the prevailing low rates. In August 1950 the Fed broke away and the New York Federal Reserve Bank increased its discount rate from the frozen 1½-percent level to 1¾ percent. For the first time in nearly two decades monetary policy was moving toward a more active role on the stabilization front.

The accord of March 1951 was in the nature of a declaration of independence for the Federal Reserve System. By the terms of this arrangement the Treasury agreed to begin the issue of a new series of nonmarketable long-term issues at 2¾ percent, a rate which approximately fitted the new pattern being established by the Federal Reserve System. The Fed began to withdraw from active support of the Government bond market. As a consequence, Government issues, left to the free play of competitive market pressures, were off more than 3 percent by the end of 1951, and by the end of the following year were selling at a 3½-percent discount. On short terms the yield rose to the 1¾-percent discount-rate level and by the end of 1951 was running slightly ahead of the discount rate. For the first time in many years the discount rate was beginning to take hold as a stabilization device.

Banks, in need of funds, found it expedient to borrow from the Federal Reserve System rather than to liquidate their holdings of shorts. By the end of 1952 the yield on Government shorts stood above 2 percent and, with the discount rate still at 1¾ percent, bank indebtedness to the System was climbing steadily. In January of 1953 the Fed raised the discount rate to 2 percent and member bank borrowings began to decline thereafter.

Simultaneously with the increase in the discount rate, the System applied further pressure upon bank reserves by selling off nearly $1 billion of Government securities in the open market. Reserve ratios required of member banks were held at effective maximum levels. As the expansion progressed in 1952 and 1953 the Federal Reserve System was applying appropriate restraining influence. The conclusion seems justified that in this early postaccord period monetary policy was effectively developed and applied. The Federal Reserve System has been criticized for tightening credit too severely in this upswing and thus precipitating the downturn of 1953–54. The criticism seems wholly unjustified. In fact, there is reason to suggest that a failure of the Fed to so act at that time might well have led to a serious inflation leading ultimately to a decline of much greater severity.

The cycle turn in midsummer of 1953–54 found the Federal Reserve System moving to ease the turn and support the economy as it moved down. By May central bank officials appear to have concluded that the inflationary pressures had been held and that the power of monetary policy should be brought to neutral and then shifted into reverse to ease the problems of the transition from expansion to contraction. In May the System began to purchase governments on the open market, thus releasing funds to the economy. In July reserve ratios were reduced, thus providing a material easing of money-market conditions. It appears that monetary policy anticipated the turn and then as the economy settled into decline reserve ratios were further reduced and the rediscount rate was lowered.

It was suggested earlier that monetary policy is less effective in a contraction than it is in time of expansion. The 1953–54 recession was primarily a time of inventory liquidation and the easy availability of credit permitted consumers to maintain high level expenditures which shortened the period of liquidation and speeded the end of the decline.

From late summer of 1954 until midsummer of 1957 the economy was expanding. What of monetary policy during this period of cyclical upswing? Stated briefly, monetary policy was shifted from a condition of active ease to a gradual hardening of the money market and, in the late stages of the upswing, to a condition of strong restraint. To illustrate—the New York bank discount rate which stood at 1½ percent in the 1954 trough was moved steadily up by ¼ percent amounts through 1955 and 1956 and was increased ½ percent to 3½ percent in August of 1957 at the approximate time of the cycle peak. The general tightening of credit terms was apparent in the pattern of yields on Government bills which moved from a 1955 average of 1.73 percent to 2.62 in 1956 and a peak of 3.58 percent in October of 1957.

Consumer prices which, on an overall basis, had held remarkably stable from 1953 through 1955 began to move up in 1956 and had risen more than 5½ percent by the end of the summer of 1957. (The increase has continued since that time with consumer prices reaching record levels in the early months of 1958.) Here was a developing inflation. How did monetary policy attempt to cope with it? As indicated above discount rates were increased, reserve ratios required of member banks were held at high levels. Excess reserves were held at minimal levels and, in fact, were forced down slightly from an approximate three-quarter billion dollars in 1954 to approximately one-half billion in 1957. Free reserves (excess reserves less borrowings) were generally negative for the period after mid-1955. And the total money supply (currency outstanding plus adjusted demand deposits) did not increase and was, in fact, forced to contract somewhat in 1957.

Clearly monetary policy was being used strongly to offset the inflationary tendencies within the economy. And still in spite of the contraction in the rate of growth in money supply inflation continued to develop. The answer here is evident, in part, in the figures which show an accelerating income velocity of money.

This table indicates that the growth in money supply was held in check effectively and in 1956 and 1957 was below long-term trends and throughout the period held at levels below the rate of growth in gross national product. Money was turning over more rapidly. And this trend could not be controlled by monetary policy.

The income velocity of money, 1953–57

Period	Gross national product		Money supply		Velocity index	
	Total	Percent change, previous year	Total	Percent change, previous year	(GNP÷M)	(1954=100)
1953	$363.2		$200.9		1.81	105.2
1954	361.2	−0.6	209.7	4.4	1.72	100.0
1955	391.7	8.5	216.6	3.3	1.80	104.7
1956	414.7	5.9	222.0	2.0	1.87	108.7
1957	433.9	4.6	226.3	1.9	1.92	111.6

In conclusion, it appears that the monetary authorities were using monetary policy about as effectively as it could be used to counteract the inflationary pressures of this last expansion. But the lack of fiscal discipline, the unwillingness or inability of the Treasury to press for higher taxes and larger surpluses during the expansion offset a well managed monetary policy program.

5. The committee has asked about the effect of debt management policies upon the national credit structure and the economy of the United States.

Clearly a Government debt equal to more than 60 percent of the national product will have impact upon the economy and the careful management of that debt is essential to the maintenance of a stable economic system. The following table may be useful in carrying this discussion forward:

Distribution of Public Debt, 1955–57

	June 1955	June 1957	December 1957
Gross debt	$274.4	$270.6	$275.0
Marketable debt	$155.2	$155.7	$164.2
Percent of gross	56.6	57.5	59.7
Change, June 1955		$0.5	$9.0
Savings bonds	$58.4	$54.6	$52.5
Change, June 1955		−$3.8	−$5.9
Marketable due in 1 year, total	$49.7	$71.0	$74.4
Percent change from June 1955		42.9	49.7
Percent, total marketable	32.0	45.6	45.3

The economic expansion of 1955–57 provided opportunity for reduction of the gross debt but the total of marketable issues increased between June of 1955 and the same month in 1957 and rose very sharply in the last half of 1957. At the same time savings bond totals, the principal item in the nonmarketable category fell consistently during this period. A sharp increase occurred in the category of market bonds due within a year. Maturities of a year or less constituted 32 percent of total marketables in June of 1955 but had risen to more than 45 percent in 1957.

This sharp rise in marketables maturing within a year means that the Treasury had to refinance some $70 billion of Government issues within the year. Refinancing of this magnitude means, inevitably, a very real impact upon the money market. Such an operation must seriously influence the terms of credit and impose special burdens upon the monetary authorities. Thus, for example, the failure of the Treasury to take a realistic view of the savings bond market caused material net redemptions of these issues, as shown in the table above. As holders of such bonds redeemed their portfolios the Treasury was forced to go into the open market for funds needed to finance such redemptions. The monetary authorities, in turn, felt compelled to provide sufficient funds to the banks to permit the absorption of the new issues. Thus again deficiencies in debt management policy impeded the effective operation of monetary policy in its attempt to curb the expansionist tendencies of the economy.

6. The committee has requested a discussion of three objectives of economic policy: (1) Price stability, (2) stability in production, demand, and employment, and (3) economic growth in production,

demand, and employment. It has also requested some comment concerning recent trends with respect to these objectives.

This line of inquiry is an excellent singling out and focussing of significant points. In reality it seems clear that all three of these objectives must be kept constantly in mind in the development of national economic policy. Economic stability was never intended to imply a freezing at any given level. It was meant to infer stability centering around a rate of sustainable economic growth.

There is for an economy at each moment in time a certain rate of growth which can be sustained without producing either conditions of under or over employment. It should be the objective of economic policy to hold the economy as nearly on course as possible. If the economy is allowed to fall below this growth line wasted resources appear, plant and equipment are not fully utilized and manpower is idle. Alternatively, if the economy pushes beyond the rate of sustainable growth, overfull employment appears with expensive bidding for materials, manpower, and managerial talent. The scramble for short supplies of all these factors of production produces wasteful cross-haulings of materials, upbidding of wage and salary levels and declines in relative productivity. These overfull employment levels are not sustainable because they carry the economy to cost levels which are not sustainable.

It is not possible to mark precisely that rate of growth which is best suited to provide sustained employment of all factors of production at levels which are neither overfull nor underfull employment levels. Perhaps something approximating 3 percent per annum, in real terms, comes close to being the sustainable rate of growth in our present economy.

There is reason for believing that the great burst of capital formation in 1955 and 1956 carried the economy to higher than sustainable levels, that conditions of overfull employment prevailed as this investment boom matured. In late 1956 and early 1957 the economy was beginning to feel the consequences of this too-rapid acceleration. Costs began to push up aggressively, prices started to climb and, in real terms, the output of the economy ceased to grow. As the economy shifted from an extraordinary rate of growth to growth at a declining rate and then no growth at all the consequences began to appear after mid-1957. The reaction to a nonsustainable, excessively large rate of growth in 1955–56 is now evident.

There are those who profess to believe that the economy cannot be held to an appropriate growth rate without a calculated and planned inflation. This point is discussed in detail in answer to question 11 (b) as posed by the committee. Here it may suffice to suggest only that a planned and publicized depreciation of the currency might, for a time, give a lift and seeming buoyancy to the economy sufficient to carry it above the sustainable growth level. To the extent that such a price-induced excessive growth was attained so then would the reaction to such an artificial and excessive level be the more severe.

The appropriate rate of growth is associated with the pattern of investment. Capital formation expenditures are undertaken in order to increase the output capacity of our resources, manpower, facilities, and managerial talent. Appropriate capital formation thus increases

the productivity of the economy, thereby permitting a greater distribution of profits, and wages without increasing prices. Price stability, in short, is quite compatible with economic growth and rising real standards of living. And price stability introduces an element of uncertainty, a speculative one, which complicates rational economic decisionmaking.

7. What is the effect of current Federal, State, and local government spending?

The following table covers the five quarters starting with the last quarter of 1956. If this is taken as "current" spending as that term is used in the committee's query then it can be seen that Government spending rose moderately in the first part of 1957 then held at comparatively stable levels through the rest of the year.

Government spending—5 quarters

Period	Federal		State and local	All governments combined
	Total	National security		
1956: 4th	49.0	44.2	33.9	82.8
1957: 1st	50.3	45.5	35.3	85.6
2d	51.1	46.3	35.8	86.9
3d	50.6	45.8	36.1	86.7
4th	49.7	45.0	37.3	87.0

The following table shows the changes from quarter to quarter and makes it easier to note differences in spending.

Change in Government spending from previous quarter

[Billions of dollars]

Period	Federal		State and local	All governments combined
	Total	National security		
1957:				
1st	1.3	1.3	1.4	2.8
2d	.8	.8	.5	1.3
3d	−.5	−.5	.3	−.2
4th	−.9	−.8	1.2	.3

Total Government expenditures increased by $2.8 billion during the first quarter of 1957 and by $1.3 billion in the second quarter. But in the third quarter, as the economy turned down, Government spending also contracted, thereby aggravating the downturn. It is when we turn to Federal Government expenditures that we note the real sources of the destabilizing trend of expenditures. Federal outlays contracted by one-half billion dollars in the third quarter and almost another billion in the final quarter of the year. Almost the entire change, quarter by quarter, can be explained in terms of variations in national security expenditures.

Only the increase in State and local government expenditures served to offset the magnitude of the Federal spending decline, counteracting three-fifths of the Federal reduction in the third quarter and more than offsetting all of the Federal level decline in the final quar-

ter. In concise answer to the committee's inquiry, Federal spending patterns in the past year have been a constant unstabilizing influence, expanding when the economy was expanding and contracting when the economy was declining. In the last half of the year State and local government expenditures have had a moderately stabilizing influence as they continue to expand.

8. What is the effect on the economy of current Federal, State, and local taxation?

Only rough approximations can be given in answer to this question since full data on State and local taxation in 1957 are not available. We may use the principal sources of State and local government revenue of 1956 to present the following array indicating the principal sources of State, local, and Federal tax revenues.

Type of tax	Percent distribution State and local tax revenue by type of tax	Percent distribution Federal tax revenue by type of tax
Property	37	
Sales, receipts	28	14.5
Individual increases	5	47.3
Corporate increases	3	30.7
Other	27	7.5
Total	100	100.0

Total Federal tax receipts run about double those of the State and local governments. The Federal system relies primarily upon income taxes, personal and corporate, with receipts from the former running half again as large as those from the corporate levy. State and local governments place their primary reliance upon the property tax (local governments) and sales and other excise taxes (State) and this suggests the difference in effect. Because of the progressive nature of Federal receipts, tax income tends to rise or fall more than the rise or fall in general economic activity. State and local taxes tend to move, with a lag, in accord with economic activity.

The Federal tax system is much better suited to the purposes of economic stabilization than are the State and local systems which tend to lag behind changes in the economy. They will extract from the private income stream reducing portions of the total income during times of expansion and greater portions in times of economic contraction. They, therefore, tend to aggravate cyclical fluctuations in the economy. Conversely, the more progressive Federal system tends to take a greater share of total national income during expansions and take smaller portions during times of decline thereby serving, in part, to offset the fluctuations of the economy.

9. The committee has requested a discussion of fiscal, monetary, and credit policies with consideration of their use to restrain inflationary trends and otherwise help in preserving a stable economy.

The concept of fiscal policy ranges over the areas of expenditure, tax, and debt policy. Each of these relates in varying ways to the matter of stabilization policy and it is the relation between each of these three and stabilization which will now be explored.

Following the pattern noted earlier we hold that economic stability depends upon the balance struck between the two flows: (1) The flow

of goods and services and (2) the flow of money or purchasing power. Expenditure, tax, and debt policy act directly upon the money flow and indirectly upon the flow of goods and services.

Tax policy considerations relate to the level of taxes and the type of taxes to be imposed upon the private economy. Broadly considered, increases in taxes work directly to reduce the supply of money in private hands. And in similar fashion, decreases in the level of taxation leave greater amounts of money in the private flow. Accordingly, it has become customary to speak of increased taxes as deflationary and decreased taxes as inflationary in their consequences. This is a useful view of the matter and a generally accurate one although some reservations may be held in abeyance for the moment and will be considered subsequently.

Viewed in this manner it follows that tax policy in a period of threatening inflation should be steered in the direction of higher taxes designed to sop up a portion of the excessive money supply. A reversed pattern of reduced taxes would be appropriate in times of deflation. But tax considerations may never be dismissed so easily. Those responsible for tax policy decisions cannot decide broadly to raise or lower the level of taxation—they must make their decisions with respect to specific types of taxes. Is an increase in the income tax more appropriate than an increase in excise taxes? If an increase in income taxes is decided upon shall this be done by raising all steps in the progressive structure, or perhaps by introducing increases only at certain parts of the tax range, or, alternatively, by simply lowering minimum exemption levels. Although each of these actions may be generally deflationary in the sense that they will withdraw purchasing power from the private economy the different proposals will have varying impacts upon different class of income recipients.

We know generally that those with lower incomes spend a higher portion of their income on consumption and those at higher levels save and invest a greater portion of their income. If the inflationary pressures in the economy are believed to stem largely from high level consumption tax increases which bear more heavily upon those with higher propensities to consume will be considered. If, on the contrary, the inflationary bulge is believed to have its origin primarily in an extraordinary level of investment spending then the tax increase will be made so as to fall most heavily upon the flow of investment.

However, it should be noted that serious practical difficulties stand in the way of an effective stabilization effort through the channel of fiscal policy. Taxes cannot be changed either up or down with great rapidity. Suggestions may be made through the executive branch which will be referred to appropriate legislative committees. Hearings will be announced and conducted. Committees will submit their reports to the Congress which may then act and refer the tax bill to the President for signature. This process may extend over months. Ordinarily stabilization actions must be taken with special regard to the importance of timing.

A peculiarly discouraging aspect of this matter is the perverse impact of the tax procedure. In times of threatening deflation the normal line of tax action involves a proposal for tax reduction. But the legislative consideration of a tax reduction may, in fact, seriously dampen both consumption and investment as those with purchasing power

refrain from committing their funds in anticipation of tax-reduced lower prices in the future. The procedural steps involved in making effective a lower level of taxes tends to further deflate the economy. And, in a similar manner, the process of moving from a given level of taxation to a higher level intended to combat inflationary trends may touch off added bursts of new spending thus further aggravating the very situation the proposed tax action was intended to correct.

Monetary policy may now be considered briefly as it relates to the problem of economic stabilization. The great virtue of monetary policy lies in its flexibility, as was noted above. Monetary policy is quick where fiscal policy is slow. It has real limitations but this is one of its strengths. The great bulk of our money supply is credit money, created by the operations of our private banking system. The banks, in conformance with requirements of law and the dictates of sound bank management, maintain an appropriate minimum level of reserves against their deposits. In recent years the legal reserve requirements have moved, on the average, in a range of 18–20 percent. While maintaining reserves of at least these amounts the banks have conducted their business affairs for profit as any other business does.

Basically there are only two things a bank may do with its excess reserves, either (1) invest them at going rates of interest, or (2) lend them to borrowers at market rates of interest for such lines of credit. Banks move their funds between loans and investments as the advantages of each rise or fall in relation to the other.

The Federal Reserve System exercises a general control over the money supply through:

(1) Changes in the discount rates.
(2) Open market operations.
(3) Changes in minimum reserve ratio requirements.

The discount rate is the rate of interest charged banks when they borrow from the Reserve System in order to replenish their reserves. Open market operations involve the purchase or sale of Government securities by the Federal Reserve System. As the System buys securities it puts added amounts of money back into the private economy, pushes up the price of Governments and thus depresses their yield. When it sells it depresses the price, raises the yield, and draws money out of the private economy.

The Federal Reserve System also has power to change the minimum reserve ratios required of member banks with discretion to move these rates from an average minimum level of 10 percent to a maximum of 20 percent. These three tools are used in harmony and are carefully coordinated. Used in this manner they permit fine gradations of impact. The full weight of an increase in the discount rate may be softened by limited amounts of open market buying to ease a part of the strain placed on the money markets by the reserve ratio action. The easing effect of a downward adjustment of required reserve ratios may be offset in part by open-market purchases. In short, monetary policy may be administered with considerable finesse to produce delicate changes in the conditions surrounding the money flow through the economy.

But there are also definite limitations on the capacity of monetary policy to cope with economic fluctuations. In periods of developing inflation monetary policy can be invoked to stem the growth or

even reduce the total money supply (although at times the constriction of the quantity of money will be offset by increases in the rate at which it is used). But in periods of economic contraction monetary policy is forced into a more passive stabilization role. Then it may ease money-market conditions but even though banks may thereby acquire additional loan potential monetary policy cannot induce consumers and investors to undertake borrowings to expand their purchases. The brakes on an automobile may be used to stop the movement of the car; releasing the brakes will not make it move again but only make movement possible if the impetus is provided from some other source.

In periods of economic contraction greater reliance must be placed upon fiscal policy to induce new spending in the economy. But fiscal policy actions normally come in "blocks." Tax levels are changed or items formerly taxed are removed from the tax rolls. Expenditure programs are approved—they are not partially approved—a new dam is authorized, not half a dam. These indivisible lumps in fiscal policy may be smoothed through the use of monetary policy, easing somewhat the the impact of higher taxes and making the shift to the new tax level a smooth one.

In periods of excessive economic expansion monetary policy must be applied firmly but should also be supported by appropriate fiscal policy actions with Government surpluses designed to withdraw funds from the private economy and ease the pressure upon monetary policy.

Further consideration of deficiencies in operation with respect to both monetary and fiscal policy will now be noted in answer to the committee's next query.

10. This question called for an appraisal of the adequacy or inadequacy of the monetary system in the United States and then asked for similar comments with respect to the fiscal system. The two seem inseparable and will be considered together at this point.

If this question having to do with the monetary and fiscal systems of the United States is taken quite literally to mean the "systems," in the sense of an organizational structure, it may be observed that there do not appear to be serious deficiencies in either system, so defined. There are some who feel that the Federal Reserve System should be given more direct control over the variety of nonbank financial intermediaries. This would include insurance companies, mortgage companies, investment houses, and sales and personal finance companies. It is clear that these nonbank institutions do handle a growing proportion of the national savings and direct such savings into investment channels. But it is by no means clear that they are not already sufficiently influenced by monetary policy actions which go first at the banks and through them have an ultimate impact upon all financial intermediaries, including the nonbank ones noted.

But there is no reason to assume that your committee intended to limit this question so sharply. If the question is conceived as an inquiry into the adequacy of monetary and fiscal policy approaches to economic stabilization a number of relevant matters deserve comment. There are clear and evident weaknesses in the operation of monetary-fiscal policy for stabilization purposes.

Timing is of the essence when dealing with the question of economic countercyclical measures. Changes in private investment multiply

out through the economy quickly and in magnified form. Changes in consumption produce magnified changes in investment and national income. These changes must be prevented from producing excessive multiplied reactions in the economy and action to contain them must be taken quickly. It is here that the great weakness of fiscal policy lies. Changed levels of either Government expenditure or taxation can now be realized only after weeks or months of deliberation. By the time action is attained minor changes of the sort noted above have produced major reactions and the corrective action originally planned is quite inadequate.

Knowledge of this laggard characteristic of fiscal policy has induced too great a reliance upon monetary policy. This seems a clear characterization of the upswing, 1954–57, where inadequate fiscal policy action placed almost impossible burdens upon the monetary authorities. Similarly, in the downturn of 1953–54 failure to move promptly and effectively on the fiscal front placed excessive pressure upon the Federal Reserve System which then responded by making sizable reductions in reserve ratio requirements. The large quantities of money set free by this action undoubtedly sparked much of the great capital formation boom which characterized the upswing from the 1954 cycle trough. Other examples could be provided in quantity. These will perhaps suffice to make the point that a general awareness of the ponderous process of effecting changes in fiscal policy has forced too great a reliance upon monetary policy.

And, to repeat a point made earlier, the process of debating appropriate changes in tax policy is self-defeating. Public notice that the Congress is debating tax reductions will cause consumers to defer postponable expenditures, thereby aggravating the decline which tax reduction was intended to counteract. And the reverse case is also true. If the Congress, attempting to enact appropriate tax legislation in a time of threatening inflation begins debate on a bill to increase levels of taxation this itself will tend to induce a wave of consumer and investor expenditures to "beat" the tax increase.

Two major difficulties arise in the attempt to use fiscal policy for stabilization purposes: (1) The delay incident to the adoption of either tax or expenditure programs, and (2) the tendency of consumption and investment expenditures to move perversely thus weakening or even more than offsetting the proposed tax changes. And still the fact remains that monetary policy, alone, is simply unable to cope with the full forces of destabilization and must be supported by and at times yield the active role to tax and expenditure policy. One proposal might overcome these indicated deficiencies of fiscal policy.

If the Congress would authorize the executive branch to move effective tax rates up or down within carefully defined limits as set by the Congress the needed flexibility, the quick and undebated alterations in tax levels would permit tax policy to be brought quickly into play at the early and critical stages in an incipient expansion or contraction. Clearly the Congress should retain basic jurisdiction over the general broad levels of taxation, but the authorization for minor variations in current levels would add flexibility not now possible.

To use the phrase to which the committee directed inquiry, the greatest "inadequacy" of monetary fiscal policy for stabilization pur-

poses stems from the procedural delays incident to the inauguration of changes in fiscal policy. Until this is corrected there will be too great a reliance upon monetary policy and danger that public consideration of fiscal policy changes will worsen rather than improve the stabilization effort.

11. (*a*) The committee has asked for an explanation of the seeming paradox that at times inflation and unemployment have existed side by side in our economy.

There is nothing really paradoxical about this once it is realized that our economy is something less than perfectly competitive. It is the function of the price system to allocate resources, capital, and manpower to their most efficient uses. Under a competitive situation, as particular types of goods pile up unsold, the producers of these goods would disemploy workers, reduce their demands for raw materials and equipment, and lower their prices to clear the market. Resources would flow out of such industries and toward others where such conditions did not prevail. If surpluses were accumulating generally in the economy prices and costs would decline generally to restore the balance.

In practice our economy, of course, is not perfectly competitive. Prices are set for contract periods, set by custom, by common understandings among "competitors." Costs are similarly set by contractual arrangement, by regulatory commissions, by contracts negotiated with suppliers and with unions. In those parts of the economy where such conditions prevail costs remain high even though sales are falling and, in fact, the reduction in volume may have the effect of raising net unit costs so that sellers are loathe to reduce their prices even though their output is piling up unsold inventories and workers are being laid off.

A second line of explanation takes into account the sources of current expenditures on consumption and investment goods in the economy. The fact that the committee has pointed to the simultaneous rise of unemployment and prices as a paradox implies that current spending is wholly related to current levels of income. But today's spending is not only a function of today's income, it is also influenced by the liquid reserves of spenders. And in 1957–58 both consumers and business firms have had moderately strong liquid reserve positions. In the initial stages of rising unemployment spenders will continue to spend to maintain their previous living standards even though this may cause them to draw down their reserves.

A third line of explanation makes simple note of the fact that unemployment may be concentrated primarily in a few industries, particularly in the early stages of a contraction, whereas employment levels may remain strong elsewhere in the economy. Likewise, the conditions of supply will be uneven throughout the economy so that critical areas of the economic system may remain, for a time, more in the grips of a sellers' market atmosphere than others. If the markets in relative tight supply are important segments of the total cost of living the weight of these limited parts of the economy which are still producing rising price trends may swamp the price declines shown elsewhere in the economy. In the first several months of the decline which started in the summer of 1957 food prices have risen strongly and since this is a dominant part of the total cost of living this more than offset declines elsewhere.

11. (*b*) The committee asked whether we should accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment.

Governments have always made strong efforts to protect the integrity of their coinage. In fact in colonial times the death penalty was imposed upon individuals who "clipped" the coins of the government. Similarly our Government works diligently to prevent the swindling of the people by adulteration of products, misrepresentation, or false labeling. In a democracy the people place their faith in the government to protect them from an adulteration of the money. It, therefore, appears to be the height of irresponsibility to suggest, as some have done, that the Government now adopt as a matter of cold calculation the regular and scientific debasement of the currency by projecting a gradual 2- or 3-percent per annum destruction of monetary values.

Inflation and deflation are simply processes by which the wealth and income of the economy are redistributed. A proposal to have the Government assure a steady rate of inflation is simply a proposal to have the Government take income and wealth away from certain classes of the population, in favor of others, through a process which is particularly mischievous because it is seldom presented to the public debate on such grounds.

It is sometimes argued that a 2- to 3-percent price increase per annum, dangled before the businessman will serve as a carrot to make him run harder in the pursuit of dollar profits. This is not only a false hypothesis but an insolent one. It assumes that the businessman will not soon learn that the larger dollars of profit may be smaller real profits, that the fixed plants and equipment which he is writing off against current earnings are being written off on a cost basis such that the reserves he is accumulating will be inadequate to permit replacement of such plant and equipment, or that his workers will not soon learn to discount future price increases in their current collective bargaining negotiations.

Even though the businessman was so stupid, and he is not, the whole hypothesis would still be a false one. It assumes that the projected price increase will compel a greater rate of capital formation than would a stable price level or, in other words, would induce a greater rate of capital formation than is justified by normal cost-price relations. If the proposition worked as its advocates posit it would, then it follows that the economy would be induced to a level of capital formation it could not sustain—an artificially stimulated boom would be followed by the bust the inflation made inevitable.

In specific answer to the committee's query, we should not accept a gradual inflationary trend—we should, on the contrary, do all within our power to resist efforts made to have the Government establish either upward or downward price trends. To the best of our ability we should attempt to maintain stable prices so that decisions by businessmen, by consumers, by farmers, in short all economic decisions will be based upon inherent cost-price relations and not upon the destabilizing force of a Government-induced inflation or deflation.

13. At what point should the Federal Government move to counteract a downturn in the economy?

There is, of course, no simple arithmetic answer to this question which can be defended under all circumstances. Without in any sense attempting to limit the matter to questions of labor force employment and unemployment but, instead, having reference to the unemployment of plant, equipment, resources, and the labor force, a point where unemployment moves into the range of 6 percent may be suggested as a rough "trigger point" for the inauguration of serious counteracting moves by the Federal Government.

It appears that unemployment did not exceed this 6-percent level in the troughs of 1948–49, 1953–54, or back in 1924 or 1927 but did move across this line in the contraction of 1929–33 and 1937–38. Contractions which do not cross over the approximate 6-percent line have been largely self-correcting whereas those which moved much beyond that point may gather momentum and call for deliberate intervention by the Federal Government. The declines which bottomed in 1924, 1927, 1949, and 1954 were essentially inventory recessions and did not involve the bulk of economic activities. In 1924 some 35 percent of all economic indexes were expanding. In 1927 the figure was even higher. In 1949 apparently some 40 percent of the series still showed expansion at the time of the cycle trough and the figure was only a little below that in 1954. In 1933 nearly 90 percent of all economic activities were contracting and the figure was approximately 80 percent in 1937. Our contraction which began in the summer of 1957 appears to be involving a larger portion of all economic activities than did these minor declines.

14. How much of a factor has deficit spending by the Government been in contributing to or producing inflation since World War II?

For information which will throw light upon the degree to which the Federal Government actually operated on a deficit basis during the postwar years the following table has been prepared. It shows Government cash receipts and cash payments from and to the public.

Federal Government cash receipts and payments, 1946–57

[Billions of dollars]

Year	Excess of Federal Government—		Year	Excess of Federal Government—	
	Receipts	Payments		Receipts	Payments
1946	(1)		1952		1.6
1947	$5.7		1953		6.1
1948	8.0		1954		1.1
1949		$1.3	1955		.7
1950	.4		1956	5.5	
1951	1.2		1957 [2]	1.3	

[1] Receipts, less than $50 million.
[2] Preliminary.

Through the peak year 1948 the Federal Government obtained net cash receipts from the public and the effect of Government balances was therefore deflationary. The year 1949 which marked the trough of the minor recession of the late forties produced a moderate deficit of $1.3, a minor inflationary offset to the economic recession. As the economic expansion resumed the Government cash position shifted to produce a deflationary effect until 1952 when the impact of the Korean war expenditures produced net payments to the economy. These pay-

ments became larger in 1953 as the economy reached its cycle peak in late summer and then began to decline. The sharp decline of net payments to the public from $6.1 billion in 1953 to $1.1 billion in 1954 meant a sharp drop in Government contributions to the declining private economy just at a time when this could be ill afforded.

As the economy began to move strongly up in late 1954 and 1955 the Government net cash payments added to the upward momentum. In 1956 net cash receipts grew rapidly to $5.5 billion, thereby counteracting, in part, the buoyancy of the private economy. But in 1957 net cash receipts fell sharply.

In the period since World War II there is little evidence that Government deficits, per se, have contributed in material ways to inflation. In 1953 when the Government made its largest net cash payments to the public these were equal to only 1.7 percent of the gross national product (and the last half of this year was a time of economic recession when deficits would have been appropriate). It is rather that Government surpluses have been reduced in times of inflation when Government surpluses should, in fact, have been increased—as witness the situation between 1956 and 1957. A rising and presumably necessary tide of defense expenditures was not matched by an aggressive drive for increased taxes so that net cash receipts of the Government contracted. The mounting inflation was aided by a reduction in the amount of cash receipts which the Government was taking from the private economy.

15. Can full employment goals be attained while maintaining a dollar which has relative stable purchasing power?

This question of the committee's appears to be closely related to 11 (*b*) which raised the question of the desirability of gradual planned inflation. There is nothing incompatible between price stability and full employment. The decade of the 1920's is illustrative. There prices were either stable or drifting moderately down while the economy remained at essential full employment levels.

16. Are escalator provisions in wage or other contracts compatible with achieving economic instability?

What invites the use of escalator clauses is the very thing discussed in detail under question 11 (*b*), the commitment to planned inflation. It is not such much that escalator clauses are objectionable as that the conditions which breed escalator clauses are, in themselves, incompatible with achieving economic stability. A fear that the Government is either unwilling or unable to prevent inflation is the situation which leads workers and others to insist upon the inclusion of escalator clauses in contracts.

Until there is a general acceptance of the importance of price stability and an aggressive effort on the part of the Government to maintain such stability there will be no reason to expect that those who now insist upon escalator clauses will reduce their insistence and, in fact, there will be reason to anticipate that the practice will spread.

One clear step which might be taken at the governmental level to make clear the Government's intention to address its efforts toward stable prices would be an amendment to the Stabilization Act of 1946 making it clear and explicit that economic stabilization includes, by specific reference, the stability of prices. The Government should be given the mandate to maintain stable prices and such an amendment

to the 1946 statute would be an appropriate place to make such a declaration of policy.

17. What are the causes of the present recession? What should be done to terminate it?

No simple answer will explain the complex and interlocking forces which produced the downturn in the summer of 1957. As this is being written at the end of March 1958, it is becoming evident that this is a different kind of decline than the inventory adjustments of 1948–49 and 1953–54. Much more of the economy is involved. The decline in capital formation is assuming serious proportions. And unemployment, although heavily concentrated in a limited number of industries, is involving a greater portion of the labor force than the earlier declines did.

A search for the causes of this decline must give close attention to the tremendous capital formation boom which was underway as early as 1955 and continued at high level well into 1957. It must also take into account the slow decline in productivity figures over this same span of years. And it must note the gradual emergence of strong inflationary tendencies, which obscured the decline in the rate of growth and of the national product. It must also note the fact that residential construction reached a peak early in 1955 and began to slide thereafter. It may also note how total investment figures were concealed by the sharp rise in exports incident to the Suez crisis at the same time that a sharp rise in inventory liquidation was taking place at the end of 1956 and in early 1957. It will note how consumer expenditures which had moved strongly up in 1954–55 began to level off in 1956 and, when discounted for price inflation, failed to grow at all in the first half of 1957. It will also take into account the fact that average weekly earnings of manufacturing workers, which had edged steadily upward from 1954 to the end of 1956, thereafter began to decline while average hours per week were declining steadily after mid-1955.

It may also be noted that the increase in debt was less in 1957 than in 1956 and that in 1956 was, in turn, less than the increase in 1955 and that this was true of mortgage debt, consumer debt, and business loans from commercial banks. It will also be seen that the banks increased their indebtedness to the Federal Reserve System in 1955 and remained in debt in 1956 and 1957 and that their free reserves (excess reserves less borrowings) were negative during most of this period.

What caused the present recession? Primarily it was caused by the expansion which preceded it. In the early stages of the expansion from the trough in 1954 consumption expenditures moved out strongly. Investment expenditures responded and easy money market conditions facilitated a tremendous wave of capital formation. It now appears that business anticipations were excessively optimistic—that a good part of this optimism was based on the strength of consumer demand.

Much of the explanation for the strength of consumer demand may be found in the figures on consumer credit. During 1955 consumer debt increased by more than $6 billion; in 1956 it increased by another $4 billion. Consumer debt positions were not critical but consumers by 1957 were catching their breath, were repaying past debt, and

reducing the rate at which they assumed more. They were spending more on maintenance and upkeep of homes they had acquired earlier and were beginning to postpone the purchase of new model durables. The rate of growth of consumption, which had stimulated business investment, was slowing and it now appears that by 1957 capacity had been built to excessive levels in many industries. The demand for new plant and equipment began to bear the brunt of this changed situation. And inventories which had been built up substantially to accompany the rate of growth in consumption after 1954 began to appear excessive by the end of 1956 and new orders were beginning to fall as attempts were made to get inventories back into line with sales. In the early months of 1957 a major reduction in inventory investment took place.

What caused the recession of 1957–58? In brief, and in an attempt to offer a generalized answer, the recession was brought on by too rapid a growth of investment, including inventories, construction, and plant and equipment expenditures. This growth in investment was geared to the rate of growth in consumption and not to the levels of consumption and could not be sustained. The final straw which broke the back of the expansion was the unexpected and extremely sharp cutback in Government outlays in mid-1957. But the economy was already overextended and vulnerable. Ebullient optimism changed to cautious conservatism. Stock prices broke down in August and by year end had declined by more than 10 percent.

PRINCETON UNIVERSITY,
INDUSTRIAL RELATIONS SECTION,
Princeton, N. J., April 8, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: This is in response to your letter of February 17 enclosing a list of questions in connection with the Senate Finance Committee's inquiry entitled "Investigation of the Financial Condition of the United States."

Rather than attempting to answer all 17 questions, which for adequate response would require a document of 40 or 50 pages, I have concentrated on 4 questions and am giving fairly brief answers to them.

The answers are enclosed, numbered according to the number of the question in the submitted list.

Very sincerely yours,

RICHARD A. LESTER,
Professor of Economics.

REPLY OF PROFESSOR RICHARD A. LESTER, PRINCETON UNIVERSITY

2. The economy of this country could best avoid either inflation or deflation (1) if the Federal administration were more acute in its perception of economic changes, (2) if the Federal Reserve authorities made fewer mistakes of diagnosis and were more concerned with production than with the Consumer Price Index, (3) if the monetary system were less directly tied up with the expansion and contraction of bank credit, (4) if Federal authorities had more control of consumer credit, and (5) if built-in stabilizers were made more effective.

I shall briefly explain each of these points. Before doing so it should be stressed that, since World War II, practically every country has been experiencing almost a continuous upward rise in its price level. This country appears prone to have some sort of slump or economy readjustment about every 4 years—1949–50, 1953–54, and 1957–58. Some of these "recessions" are largely inventory in character; others also affect capital-goods investment significantly. Consumption usually falls off only slightly, but a slight drop in consumption has a magnified effect on induced investment, including inventories.

The Eisenhower administration has clearly misjudged economic developments during 1957 and the first quarter of 1958. The President, in September 1957, after the Federal Reserve index of industrial production had been falling for over 8 months, recommended that people be more cautious in their buying for consumption. The January 1958 Economic Report was out of date before it was issued. Just before the President's report was released I wrote the enclosed

letter, indicating how many economists were diagnosing the situation (letter to Tyroler).

The Federal Reserve authorities were raising the rediscount rate as late as August 1957 and pursued a tight-money policy far too long and with too much vigor in the latter half of 1957 and early 1958. They apparently had their attention too much on the Consumer Price Index and not enough on basic changes in the economy—industrial production, planned investment, and consumers' outlook and plans. The Consumer Price Index is a misleading guide for Federal Reserve policy. Not only is it too influenced by temporary factors (such as the weather destroying fresh fruits), but services account for one-third of the weights, and they lag in their movements—public utility rate cases take a long time to settle. Also, the index does not take sufficient account of changes in quality.

Between July 1957 and January 1958 the total of demand deposits and currency (seasonally adjusted) declined from $136 billion to $132.1 billion. Most of the $4-billion contraction was in demand deposits. A money supply that fluctuates that way helps to aggravate cyclical movements of business. A program of 100-percent reserve money would be desirable from the point of view of economic stability, but, of course, has no possibility of adoption in the foreseeable future.

Consumer credit, especially installment credit, suffers from marked fluctuation—expanding more percentagewise than disposable income in booms (as between 1854 and 1957). In a recession the large consumer debt has an unfortunate effect on the consumption of new consumer durable goods and, therefore, on industrial production and investment. How the Federal authorities could or should exercise more control over consumer debt is a problem, but adjustments in the amount of downpayments and length of them, as in housing and stock-market margins, is a type of measure that might be possible.

The Federal Government has permitted some of the States to destroy in part the effectiveness of one of the most significant built-in stabilizers, namely, unemployment compensation. Unemployment benefits in 1957 met a smaller fraction of the wage loss from unemployment in covered employment than was the case in 1939, when benefits were first paid. This is because the States, in competing for low unemployment taxes, have kept their benefits low—a much lower percentage of average earnings that was originally contemplated or provided. A prime case in point is the State of Virginia, which has had about the lowest tax rate of any State in recent years (averaging 0.5 percent of payrolls in 1957), and also has perhaps the most inadequate benefits (providing only 8 to 18 weeks of benefits for total unemployment, which is the lowest maximum of any State).

Interstate competition in low unemployment taxes and benefits has reduced the effectiveness of unemployment compensation as a business stabilizer, not only on the consumption side, by compensating for no more than about 20 percent of wage loss, but also on the tax side, by causing the employer payroll tax to drop in prosperous times and rise in percentage terms in slumps.

The Federal Government, which was responsible for the nationwide adoption of unemployment compensation, has an obligation to put a stop to the cyclical-aggravating effects of unemployment compensa-

tion and to make its benefits sufficiently adequate so that they will help to stabilize business on downswings.

13. One cannot and should not fix upon a percentage of unemployment or of decline in industrial production or some other index, at whose occurrence automatically the Federal Government would make major moves to counteract a downturn in the economy. The circumstances vary too much from one downswing to another to substitute a mechanical calculator for expert judgment and wisdom.

One important area in which the Eisenhower administration to date has failed badly in the current recession is that it has tried to fool the public by rosy predictions and to talk as though it would do something without, however, making definite plans and preparing a definite program. The announcement of intentions and a program of steps that will be taken if and when circumstances become such and such, provides businessmen and consumers with a basis for making their plans. In contrast, the confusion, the fluctuation, and the patently foolish statements of the administration, particularly the President, have served to shake confidence in the leadership at the top and have thus aggravated the downswing.

16. Escalator provisions in wage and other contracts are compatible with the achievement of economic stability. They do, however, when providing adjustment on a quarterly basis, mean a quicker catching up with price rises than under annual changes. However, annual negotiations can be just as inflationary if they anticipate future increases in the price level.

Long-term contracts can, however, help to give an upward bias to the price level where the bulk of long-term agreements are not renegotiated during a short recession and there are important orbits of compulsory comparison between unions and companies whose agreements expire in 1 year (say autos in 1958) and some of those not expiring until a year or two later (as steel and electrical equipment in 1958). The result can be that the pattern of considerably reduced wage increases or of no increase in periods of recession (as in 1949–50 and, to some extent, 1953–54) may be upset and the average of wage increases in recessionary periods may not be much below those in more prosperous periods. This matter is briefly discussed in the article I published in the New Republic for January 6, 1958, page 10.

17. The causes of the present recession are many in the sense that what occurs is influenced by numerous preceding events. Certainly, as explained in the answer under 2 above, the Federal authorities—the Eisenhower administration and the Federal Reserve authorities—are partly responsible in view of their mistaken judgments and mistaken actions. The sharp cutting of military expenditures in the third quarter of 1957 in order to keep under the $275 billion debt ceiling was a contributing factor.

As for action that should be taken to terminate the recession at this fairly advanced stage, the most effective measure would be a refund of say 10 percent of 1957 taxes. This would have a number of advantages over most of the proposals for a tax cut and over most increased expenditure programs.

It would not involve any change in present tax rates or in current withholding. It would provide taxpayers with a significant sum at once and not in driblets that surveys indicate would be either saved or used for nondurable items. It would provide money for people who

were working in 1957 but became unemployed late in 1957 or in 1958.

Such a tax refund ought also probably to be accompanied by a reduction in the taxes on consumer durables, providing that the tax cut was passed on in the form of a corresponding reduction in price.

The trouble with expanding public-works expenditures on a large scale is that it takes a year or two to make the plans, buy the land, let the contract, excavate, and get to peak employment on the project, and most of the big projects are outside the centers of unemployment.

With a prospective deficit of perhaps $5 billion in the Federal budget for 1958–59, assuming no additional expansion in expenditures or cut in taxes, the great threat is of a bunching of Government expenditures in late 1959 and 1960 at the same time that businses is experiencing a rapid recovery. The consequence may well be a significant rise in the price level that can hardly be avoided because of commitments made in 1958. A 1957 tax refund of, say, 10 percent has the advantage that its effect would largely be confined to 1958 if it occurred before July 1.

In order to indicate the basis for my belief that some such measure as a tax cut like that proposed above is necessary—indeed is long overdue—I enclose a copy of a letter I wrote February 24 to the New York Times (published March 2) and a copy of a statement I prepared upon request, which appeared in the New Republic for March 17, 1958, page 16.

JANUARY 16, 1958.

Mr. CHARLES TYROLER II,
Executive Director, the Advisory Council of the Democratic National Committee, Washington, D. C.

DEAR CHARLES: Since I will only arrive just before noon tomorrow and could not get in touch with Ken Galbraith today, I am writing this letter to indicate my point of view on the item scheduled for the morning session, namely, the economic outlook for 1958.

In my judgment, the administration is altogether too optimistic about the outlook for 1958, and the reasons that President Eisenhower has given in his budget message for expecting an expansion "soon" are mostly long-term reasons, such as rapid technological advance and growing population, or they are reasons which rest on some weak reeds such as the increase in State and local spending.

My pessimism about 1958 arises out of a number of considerations:

(1) Employment has declined very rapidly in the last month and business confidence is rather significantly shaken.

(2) The economy now has a great deal of overcapacity so that easy money is less effective as a stimulant to investment.

(3) The recession appears to be much more widespread throughout our economy than was true in 1953–54 and also much more widespread internationally so that our exports are falling off.

(4) My information is that the survey of consumer spending plans which will be released in the near future is much more pessimistic than the preceding one.

(5) No development is on the horizon which would be a significant updraft to our economy, unless it is Federal spending. The areas of capital investment, housing, and even consumer expectations cannot be looked to for much help.

(6) Arthur F. Burns talked to our seminar last night and he analyzed the situation and gave it as his opinion that the recession this year is likely to be more severe than the one in 1953–54 and he saw no good grounds for the general consensus that things would pick up by the middle of the year, although he was not denying that that was a possibility.

(7) Yesterday the employment security division in New Jersey estimated that we have 200,000 unemployed in New Jersey, which would be almost 10 percent of the work force and their reports from employers on employment over the next few months indicate some additional decline until the end of January and then a leveling off.

Under all these circumstances, it would seem to me that this meeting is the most important one that our committee is likely to have in the first years of its existence and it seems to me incumbent upon us to provide a strong antirecession program which the present administration has not done and is not likely to do if the comments of the President in his press conference yesterday and in the budget message are an indication of the administration's sentiment.

Any such antirecession program should have among its elements the following:

(1) Clear-cut assurance that the Federal Government is prepared to take action quickly if the recession becomes any more severe or continues any length of time. This kind of assurance is necessary in order to restore business and consumer confidence.

(2) An increase in Federal spending for much-needed items, including defense, basic research (which today's paper indicates it is proposed to cut in half), education, health, and State aid.

(3) A drive to improve the level of unemployment benefits in the States and old-age benefits.

(4) Consideration of a tax-reduction program.

It seems to me that we face a real serious situation in the free world if we permit a continuation of a large volume of unemployment in this country and a spreading recession in the economies of our allies. In the cold war, economic recession in the economies of the Western World would constitute a major defeat.

I look forward to seeing you tomorrow.

Sincerely yours,

RICHARD A. LESTER,
Professor of Economics.

[The Times]

TO COMBAT RECESSION

PROSPECTS OF EARLY UPTURN DOUBTED, SPECIFIC PROGRAM URGED

(The writer of the following letter is professor of economics at Princeton University)

To the EDITOR OF THE NEW YORK TIMES:

We are threatened with sharp political division on the course of the current recession and the proper way to restore prosperity. It would be unfortunate if the Eisenhower administration should rigidify its

defensive position on the diagnosis and treatment of our economic difficulties in disregard of the calculations and advice of experts.

Actually, prominent Republicans and administration advisers, as well as business and academic economists, have recently expressed conclusions varying significantly from the economic pronouncements of administration spokesmen.

GOVERNMENT INTERVENTION

A week ago Prof. Arthur F. Burns, of Columbia, former Chairman of the President's Council of Economic Advisers, declared that there was insufficient evidence to justify any prediction of an early end to the recession and that it would not be terminated by private expansion, but only by massive Government intervention. Those who have heard Professor Burns recently know that he is more pessimistic about the prospects for a pickup by the usual means than are administration statements.

Among experts there seems to be rather general agreement that, without aggressive Federal action to counteract the contraction, this recession will be more severe and protracted than those of 1949 and 1953; the upswing, when it comes, is likely to be less vigorous and less unemployment absorbing than the upswings that followed the two previous recessions, and international conditions have deteriorated so that it is dangerous now to gamble with a program of rosy predictions and halfhearted action that will be too little and too late.

Those opinions rest on such facts as the following: Compared with the previous two postwar slumps, this one has been more extensive, with all major private sectors, including exports, contracting.

Corporation and consumer liquidity have declined. The recent investment boom has produced large and widespread excess capacity, thus reducing the stimulating effectiveness of monetary policy. Also, the economic situation internationally has worsened and is weaker than during our two preceding downswings.

PRESENT PLANS

Consequently, in the absence of more vigorous Federal spending or tax-reduction measures, no development on the horizon promises a strong economic updraft over the next year or so. Plans for capital investment, housing, consumer, or State and local government expenditures offer little hope of strong pressure to bring about a significant early upturn.

Under the circumstances, this country can hardly afford the waste, the loss of prestige, and the disruption to international economic and political relations that a protracted recession here would create. In the cold war, economic recession and restrictive policies in the West would constitute a major defeat for this country, both materially and morally.

It is high time that this whole matter was given more serious nonpartisan consideration. The January Economic Report of the President is already completely out of date. Not only should the Council of Economic Advisers be requested to update that report, but a group

of experts should be called to Washington to help prepare a fresh analysis and a specific program.

RICHARD A. LESTER.

PRINCETON, N. J., *February 24, 1958.*

In support of his prediction of last November that "the present decline in business will be shorter and milder than the contraction of 1953–54," Professor Slichter now offers an analysis that seems deficient on two scores: insufficient account is taken of expenditure plans and some important factors are neglected.

With respect to plans, the November-December Michigan survey of consumer buying intentions and outlook showed the most gloomy expectations in 5 years, even among the higher income consumers, and the surveys of planned business expenditures for plant and equipment have forecast a marked downward shift. The consumer forecasts have since been confirmed by the sharp drop in new auto sales and a considerable reduction in department store sales, and the declines in the past 6 months in disposable personal income and in security prices will depress spending over the near future.

As for the neglected factors, they include the reduced liquidity of business firms, the large and widespread excess of industrial capacity built up in the recent investment boom, the continued decline in our exports in the past year, more unfavorable international conditions than prevailed in 1953–54, and a slump in business confidence in the Eisenhower leadership so that "chinsup" pronouncements are followed by declines in stock prices.

Professor Slichter's rather optimistic prognosis not only rests on somewhat questionable analysis but, in part, on hopes that Congress "will wisely insist on spending more" on constructive programs than the President has recommended and that the Federal Reserve authorities will engage in an "aggressive easing of credit."

What is needed, however, is a definite program for action that will restore confidence by indicating a determination to take specific steps over the next few months, including measures unmentioned by Slichter, such as the Kennedy-McCarthy bill to provide decent benefits for the jobless. Such a program should not be hampered by worries about the Consumer Price Index, which suffers from temporary developments like the weather and has a short-run upward bias now because of various lags.

RICHARD A. LESTER,
Professor of Economics.

PRINCETON, N. J.

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UNIVERSITY OF CALIFORNIA,
DEPARTMENT OF ECONOMICS,
Berkeley, Calif., March 27, 1958.

Senator HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: I was very flattered by your letter of February 17, in which you request that I submit answers to a set of questions concerning the state of our economy. I did not write to you earlier because I fully intended to have my answers prepared by April 1—the deadline suggested in your letter.

Unfortunately, an emergency trip to the East and a long bout with the flu have thrown me completely off schedule, and I find now that I shall be unable to prepare a complete report in the near future without seriously neglecting my duties at Berkeley.

I shall be happy in any case to offer a diagnosis of the present situation and to suggest in broad outline certain policies which might be effective in dealing with it.

The present recession should have come as no surprise to economists. To be sure, both its timing and its depth had not been anticipated. Currently available tools of analysis and prediction make it unlikely that reliable professional forecasts can be made either of the timing of a downturn (upturn), or of the depth (height) of a recession (boom). What can be predicted reliably is that the growth of our economy will exhibit ups and downs of a nonperiodical cyclical sort. To put it bluntly, we can't have our cake and eat it too. Our decentralized economy has been performing impressively well over the long run. The very fact, however, that it is decentralized means that we cannot expect it to perform without significant fluctuations. Spontaneous high rates of growth as we have been experiencing cannot be expected to be completely painless. In a sense, then, recessions and booms are the price of a high rate of growth in a decentralized economy.

It may be worth while to make a distinction between cyclical fluctuations which reflect inventory adjustments and cyclical fluctuations which reflect equipment adjustments. The former are of short duration, and are relatively superficial. The latter are of longer duration and have greater depth. I am convinced that we are experiencing an equipment adjustment. Capacity in certain sectors of our economy has outgrown current demand for output (given the present price-wage structure). Efficiency, improving technological developments, and new products may be expected eventually to turn the tide. It seems to me, however, that the recession may be expected to deepen before an upturn takes place.

It is unlikely that we will be successful in dealing with the current recession by relying exclusively on monetary policy. The monetary authority is doing what is required, but it surely is not enough.

Turning to fiscal measures, one may consider separately tax cuts and public expenditures. Tax cuts will be effective in increasing the aggregate flow of spending, but it is not clear that this will provide the answer. A personal income tax cut will provide a boost in consumer product markets. These markets, however, have not been seriously affected by the recession, and the tax cut might easily contribute to already present inflationary pressures in the midst of widespread unemployment. A reduction in the corporate income tax might lead to the undertaking of marginal investment programs by business firms, but unless the whole atmosphere is right these may not amount to a great deal. Also, a tax cut is hard to reverse.

I am much more impressed by the likelihood of success (success in the sense of cushioning the recession) of public expenditures. Public expenditures can be structured along regional lines in a fashion which will provide relief exactly where it is needed. Admittedly it takes time to begin spending appropriated money, but if my guess is correct that the recession will have depth and length this should not be a serious obstacle. It is not necessary for me to detail the nature of public expenditures which might be undertaken. Military projects, highway construction, and school-building programs should provide the major outlets. So far as the magnitude of the required expenditures is concerned, one can only guess. It seems to me that additional expenditures of between 5 and 8 billion dollars over the next 2 years will be adequate in providing a high floor to the current recession.

Please accept my sincere apologies for not sending you a more complete document. My personal circumstances have rendered this impossible.

Sincerely yours,

ANDREAS G. PAPANDREOU,
Chairman, Department of Economics.

MASSACHUSETTS INSTITUTE OF TECHNOLOGY,
DEPARTMENT OF ECONOMICS AND SOCIAL SCIENCE,
Cambridge, Mass., March 25, 1958.

Senator HARRY F. BYRD,
Chairman, Committee on Finance,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: Your questionnaire reached me at a very busy time. So I have been forced to reply to it briefly, concentrating on those questions where my specialized knowledge is greatest.

If you should want expert testimony, I would be glad to appear at an agreed upon time.

Sincerely,

PAUL A. SAMUELSON.

Enclosure.

ANSWER TO QUESTIONNAIRE OF COMMITTEE ON FINANCE BY PAUL A. SAMUELSON, PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Because of limitation on time, I am confining my replies to those questions where my views are likely to be most helpful.

Question 4

Last fall I attempted a diagnosis of the basic causes of the "new inflation" for the Sydney (Australia) Morning Herald financial supplement, and I enclose that analysis.

This was prepared at the request of the financial editor of the Sydney Morning Herald for its annual financial supplement, fall, 1957.

"WAGES AND PRICES IN THE UNITED STATES: FALL, 1957

"For a year and a half now the American Consumers Price Index has been steadily rising. There is much concern over this fact—in Congress, in the press, and in the public at large. The increase in prices has made labor anxious for further increases in wages. And it has started talk about the 'new inflation'—which is allegedly a new kind of price spiral not covered by the classic economics textbook analysis of inflation.

"I must confess that I was one of the economists testifying before Congress who can be held responsible for launching the notion of a new kind of inflation. Yet I am not sure the new inflation is really new, and I welcome the opportunity to review recent American price and wage trends.

"THE WAR'S AFTERMATH

"From 1945 to 1948 prices rose mightily in American markets. Removal of direct controls on wages and prices was, of course, the immediate occasion for the rise. But at the time most of us economists were inclined to speak of the wage-price spiral, using the words 'wage' and 'price' in that order.

"We tended to regard trade-union leaders such as the mineworkers' John L. Lewis and the autoworkers' Walter Reuther as the causal movers in this scenario. Many American economists then tended to attribute the price increase to a unilateral push from wages to prices.

"KOREA AND ITS AFTERMATH

"By 1948 prices generally began to level off. Then came the 1950 Korean war, sending staple prices skyward and unleashing a great deal of forward buying by consumers and businessmen who remembered the shortages of World War II. To the great surprise of most economists, after 1951 wholesale prices began to decline. And for the next 4 years we witnessed the satisfying spectacle of generally high American prosperity accompanied by little concern with an inflationary price spiral. While staple prices and other wholesale prices fell, our cost of living began to level off.

"By the middle 1950's many economists began to reconsider their wage-push diagnosis of the immediate postwar price rise. They began swing over to a quite different view: Namely to attribute the 1945–48 price increase to the swollen dollar demand that emerged as a result of the vast wartime accumulation of money and other liquid assets.

"In short, there was something of a flip-flop by economists from a 'wage-push' to a 'demand-pull' diagnosis of inflation. The wage rise was felt to follow on and reflect the price rise attributable to the pull of demand. And one group of economists, far from attributing that inflation to unions, began to argue that union lags in contract negotiation actually slowed down the wage rise.

"RECENT RESUMPTION OF INFLATION

"On the whole up to 1956 American economists ceased to talk much about the old dilemma of whether you can have simultaneously free markets, very high employment, and stable prices. From 1951 to 1955 American had for the most part all 3 of these good things.

"But all good things must come to an end, and since late 1955 prices have been rising. The rise showed up first in wholesale prices. The prices of industrial goods particularly showed a steady rise. Then by 1956 the Consumers Price Index began the steady increase which has continued up to the present day.

"Indeed just in the spring of 1956 when Arthur F. Burns, Eisenhower's eminent economic adviser up to last year, was making an important speech in which he argued that inflation was far from inevitable, actual prices were beginning their upward drift. This drift in consumers prices, the ones that figure in the cost of living, has been all the more remarkable in that by late 1956 American production had leveled off. And consumers prices have this year been rising in the face of declining metal and other wholesale prices.

"We have been in the paradoxical situation of having inflation at a time when manufacturing capacity has been in many industries above actual demand. Examples are the paper, auto, and steel industries; or TV and other consumer appliance lines.

"Or take the case of residential housing. The 1955 peak of 1.4 million housing starts per year has been followed by a fairly steady decline to the present level of about 1 million. Yet despite this reduc-

tion in volume, costs of housebuilding have continued to rise at a rapid rate.

"To sum up. If one ticks off in turn the usual factors that measure strength of 'demand pull' on prices, one finds in the last year that they seem rather on the weak than on the strong side. (The main exception to this may be in the field of durable equipment where 1956–57 demand has been quite strong and where there has also been a significant rise in prices.)

"A NEW INFLATION?

"It was the above facts that a number of us economists testified to before the Joint Economic Committee of Congress early this June. The financial reporters picked up this paradox of rising prices in the face of apparently weak demand and played up the concept of "the new inflation." Since then, Senator Byrd and several other public figures have also emphasized the concept of a new inflation.

"Now exactly what is the term supposed to mean? To some analysts, there can be but two kinds of inflation: demand-pull and wage-cost push. If you have eliminated the former, then by elimination you can prove that we must be in the latter. This then must be a wage-cost-push inflation. So goes the syllogism.

"And important new policy implications are drawn from the premise that this is a new inflation. Conventional Federal Reserve monetary policy—such as contractionary open-market sales of Government securities, raising of the discount rate, and raising of legal reserve requirements that the commercial banks must keep against their demand deposits—is usually thought of as operating on demand. So, if the inflation is not due to demand-pull, some jump to the conclusion that conventional central bank monetary policy is not the proper way to fight the inflation.

"And a similar inference is drawn as to the advisability of conventional fiscal policy—of increasing the budget surplus by raising tax rates and cutting government expenditure. If the new inflation is not caused by excessive demand, fiscal measures to curb demand are deemed by some not to be in order.

"SOME DOUBTS

"What are we to think of these views? First, note that two different issues are involved—an issue of diagnosis and an issue of therapy.

"With respect to diagnosis, we have to question that inflations can be simply divided into the two mutually exclusive categories of demand-pull or wage-push. Actually, there are all sorts of inbetween situations where the exact direction of causation is hard to determine and is certainly not one-directional.

"And with respect to therapy, it is not necessarily valid to argue that an inflation that one could identify as caused by wage-push can never be controlled by monetary and fiscal policies aimed to affect demand factors. For it might be the case that the push of wage increases can prevail only because demand factors happen to be permissive. Thus, if the Federal Reserve makes money very tight, a push of wages may have to result in unemployment and cuts in production. In the face of growing unemployment and declining pro-

duction, the forces working toward an upward push of wages may find themselves overcome by counterforces. Hence, one way of putting out a fire caused by wage-push might be to use the chemicals of demand-depressants.

"THE FEDERAL RESERVE'S DILEMMA

"I suspect that something like this philosophy must be in the mind of Wm. McChesney Martin, Jr., Chairman of the Federal Reserve Board, whose frequent testifyings before Congress this summer have been alarming some Wall Street speculators. The Fed acts as if it feels that it has demonstrated its ability to end recessions of the 1953–54 type and is out to show that it can also succeed in curtailing inflation.

"If this is its goal, it has its work cut out for it. To curb by demand depressants an inflation that is due solely to wage-push and not at all to excess-demand could mean you succeed only by engineering at least a mild slump. Politically, this is a risky business. The Fed could win a pyrrhic victory that all friends of central banking might later regret.

"STRONG WAGE-PUSH SINCE 1950?

"This makes it all the more important to try to decide how much of our recent inflation has been due to unilateral wage pressures. Certainly if one clips the newspapers systematically, one does not get the impression that the great trade union leaders have been acting up unusually much in the last year. Except for the midsummer steel strike, 1956 seemed a year of less-than-normal strikes. Collective bargaining seems to be these days conducted in a less warlike mood than was true some years ago.

"Yet it has been the period since 1950 in which money wages have been advancing most rapidly relative to prices. The fall in farm prices long hid this fact.

"If the indexes of fireworks in collective bargaining do not seem to indicate strong unilateral pressure from the wage side, how can I account for the inflation we've had? Can it be due to the automatic escalator cost-of-living clauses that have been increasingly written into wage contracts since the famous 1950 General Motors-United Auto Workers' agreement?

"REAL WAGES SURPASSING PRODUCTIVITY GAINS

"Undoubtedly, once the price index begins to move, these escalator clauses do become a reinforcing factor making for inflation. Statistically, though, this seems as yet to have been a minor factor in a causal explanation of events since 1951. Only 4 out of 67 million workers are now covered by escalator cost-of-living clauses.

"And most of what has to be explained is not a rise in wages just big enough to match the upward increase in prices. Rather we have to explain the fact that since 1951 our money wages have been steadily rising faster than prices. Indeed the wage increases have been greater than the increases in physical labor productivity that were simultaneously taking place.

"Perhaps more important than the cost-of-living escalator clauses in wage contracts have been the "built-in improvement clauses" in such contracts: These improvement clauses automatically give workers higher wages with each passing year, on the theory that they reflect steady improvements in productivity. And workers, whether or not covered by such clauses, have come to expect such steady increases in real wages—independently of whether or not their productivity has in fact gone up in step.

"DIAGNOSIS

"Very tentatively, I might put forward the following interpretation of the present American scene. Labor and management accept it as axiomatic that money wages will rise each year. So the wage-push no longer requires a collective-bargaining battle or a grim recourse to strikes. Labor's wage-push is, so to speak, a push against an open door. Our high prosperity in the 1950's has made no one of the participants in this process have reason to regret greatly his actions.

"If this is truly the developing pattern, then militant Federal Reserve policy may be able to break this pattern only by making labor and (particularly) management regret its participation in the steady wage-push. Can we expect that mild depressants can accomplish this?

"I hope this tentative diagnosis is wrong, for those who worry about mild price inflation may find it a pessimistic one.

"PAUL A. SAMUELSON.
"*Massachusetts Institute of Technology.*"

I would today reinforce the view expressed above that in 1957 a general excess of demand over supply did not seem evident. Hindsight tends to confirm one's suspicions.

Question 5

Public debt management is closely connected with monetary policy. Now that the Fed tends to operate in short-term bills only, it is the Treasury's decisions with respect to stretching out the debt that have many effects on the pattern of bond yields that open-market purchases of bonds by the Fed used to have. If one wishes to make long-term credit easier to get and cheaper, one foregoes stretching out the debt. Conversely, in times when fixed investment is over brisk, and the market will not buy new long-term Government bonds except at a very high yield—then, unpopular as this may seem to the Secretary of the Treasury, that is the time to issue new long bonds.

The Federal Reserve does not have the duty to keep Government bond yields low through thick or thin. But it does have the duty to make sure that the combined impact of Treasury debt-management policy and its own policies are conducive to aggregate stability.

Question 6

Our primary goal should be "economic growth in production, demand, and employment." Mere stability in these would be equivalent to stagnation. Other things being equal, stability in the price index is to be desired. But recent experience, confirmed by economic analysis, suggests that America may not be able to enjoy high and growing production along with stable average prices. One or the

other may have to give. Which? In this period of intense competition with Soviet Russia, I'd regard modest increases in prices as the lesser evil.

Question 11

See reply to question 4.

A gradual inflationary trend should not be accepted as in itself desirable. Nor are we sure it is necessary. But if it should turn out to be necessary, see answer to question 6 for national priorities in this age of competition with Russia. (NOTE.—We do not know that continuous mild inflation must necessarily "snowball" into stronger inflation. Nor do we know that long maintenance of high demand will boomerang in a depression later. Most confident generalizations in this field are based upon uncertain knowledge, since neither economic history nor economic analysis provide us with definite answers.)

Question 12

Minor problem.

Question 13

It is the important duty of the American Government to step in with countercylical fiscal policy whenever the economy is seriously departing from stable growth. The Federal Government has immense reserve strength in its "financial condition," so that is no problem. The problem is that we should not overdo things on the expansionary or contractionary side.

Question 14

Postwar fiscal policy has on the whole been well-devised.

Question 15

See answer to questions 4, 6, and 11.

Question 17

The 1957 recession came from (1) cuts in defense spending, (2) cuts in fixed investment spending by business, (3) inventory decumulation, and a number of minor factors. Expansionary monetary policies by the Fed and Treasury, increases in much-needed public expenditures, and some judicious tax cuts will bring the recession to an end.

MACHINERY AND ALLIED PRODUCTS INSTITUTE,
Washington, D. C., April 1, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

MY DEAR SENATOR: I promised in my letter of February 28 to send something in response to the questionnaire accompanying your letter of February 17. I regret to say that as things have turned out this has proved a rash promise. I have been preoccupied with pressing duties and have been quite unable to find time for an adequate discussion of the varied and complex issues propounded.

It happens that I prepared an article recently for the Committee for Economic Development (published in Problems of United States Economic Development, vol. 1), which deals with a problem that runs through most of the questions posed by the inquiry, namely, the problem of inflation. I am venturing to enclose a copy of this article, not as a direct reply to your questions, but as a means of indicating in part what I would have said in such a reply.

I regret exceedingly that I have been unable to do more on this assignment, and I tender my sincere apologies.

Respectfully,

GEORGE TERBORGH,
Research Director.

Enclosure.

WAGE-INDUCED INFLATION [1]

The next couple of decades promise plenty of economic problems for the United States and a choice of the most important is not easy. No one problem can be expected to remain continuously preeminent over so long a period, for relative urgencies will shift with changing conditions. The choice, I take it, should turn on relative importance over the period as a whole. On this assumption I have selected a long-range problem that promises to be with us most of the time over the next 20 years, and that from all present appearances may well be with us at the end. I refer to the problem of maintaining a satisfactory level of production and employment without creeping price inflation.

While this problem has other aspects, the heart of it is a lopsided balance of power between management and labor in modern collective bargaining. With the privileges and immunities that labor unions now enjoy, it has become impossible, under conditions of reasonably full employment and expanding production, to hold the average rise in labor costs to the average rise in productivity. The inevitable result is a creeping advance in the general indexes of prices and living costs.

[1] Published by the Committee for Economic Development in Problems of United States Economic Development, vol. 1, January 1958.

We hasten to say that this proposition implies no criticism either of union leaders or of the rank and file. The labor movement represents a cross section of the American public, no better and no worse than the rest. Nor does it concern the so-called abuses of unionism, recently dramatized in the activities of Dave Beck, Jimmy Hoffa, and Johnny Dio. Deplorable as they may be, these abuses have comparatively little to do with the problem. They could be totally eradicated and it would still be with us. For it arises, not from the unlawful, but from the lawful, operations of unionism.

This is not an essay on demonology, therefore; it is on social institutions. The fault lies in the lopsided balance of power created by these institutions, not in human wickedness. Nothing is sillier than to blame unions for taking advantage of the power that is lawfully theirs, and certainly nothing is more futile than to hope that they will voluntarily forego its exercise. The remedy lies rather in institutional reforms that will create a noninflationary balance of power in collective bargaining, that is to say, a balance that will hold the general advance in labor costs to the general rise in the productivity of the economy.

I have nominated the problem of wage-induced inflation as the most important for the next 20 years, in part because the remedy seems so far away. For a condition precedent to remedial action is an agreed diagnosis. At present there is none. Union leadership still denies that the problem exists. The upcreep of prices is attributed to the excessive profits of greedy employers, who could absorb wage increases if they only would. It is still possible to find university professors who insist on theoretical grounds that collective bargaining cannot raise costs and prices above the level that would obtain in its absence. But even among those less obviously self-interested or doctrinaire, there is as yet no clear agreement on the problem. Public opinion remains either confused or nonexistent. As for the politicians, a subject so politically delicate as excessive wage demands is avoided if possible, and is mentioned if necessary only in terms of studied equivocation.

The standard posture of the politician in addressing this issue is a straddle. He implies he really doesn't know whether price inflation is due to excessive wage settlements or to excessive profits. So far as he can tell, both are equally to blame. He proceeds therefore to pious admonition to both labor and management, urging the one to be moderate in its wage demands, the other to be moderate in its pricing policy. It goes without saying that the public gains no enlightenment whatever from this political balancing act.

This is said, not to blame the politicians—I do not ask them to be heroes—but simply to confirm the absence of any strong sentiment against excessive wage settlements. There does not yet exist the necessary basis in public opinion for an attack on the problem.

We are the victims of a cultural lag. In this day of huge, monolithic labor monopolies, endowed with special privileges and immunities by the state, we still retain the attitudes and sentiments of an earlier day when a weak union movement was struggling against heavy odds. Labor is still regarded by most people as the underdog, and the public reaction to union wage demands is still, in the main, indiscriminately favorable. Thus when a powerful union leader in an al-

ready high-wage industry announces that he is going to exact 45 cents an hour in the next contract, the announcement is greeted, not with anguished protest, but with acquiescence or even positive approval.

This reaction is due not only to long emotional conditioning, but also to widespread acceptance of the myth, sedulously propagated by union leadership, that wage increases can come out of profits. They may come out of profits for brief periods of time in particular situations, but they cannot do so generally and for long without killing off production and precipitating a recession. We have had enough wage increases in the last 10 years to wipe out profits many times over, but they are still with us. Industry has passed on to the market in higher prices substantially all of the increase in labor (and other) costs not offset by rising productivity, and it will have to continue to do so if we are to maintain a prosperous economy. The notion that wage increases in excess of productivity can be "absorbed" is a popular delusion.

Another reason for the indulgent attitude of the public toward excessive wage demands is the common belief that wage increases initiated in one industry or sector of the economy will spread to others, with benefit to workers not directly involved. This belief can be summed up in the slogan "We'll get ours later." To what extent and under what conditions this expectation is valid, is a matter of debate into which I need not enter. For the point is simply this. Even if the expectation were completely valid—even if everyone were to keep pace with the wage leaders—the result would still be inflation. And inflation is the problem I am talking about.

Since the necessary climate of public opinion for an attack on wage-induced inflation does not yet exist, I can only conclude that we will have to live with the problem for a good many years. This does not mean that the upcreep of living costs will be continuous and uninterrupted. There may be times when falling raw-material prices (for example, the falling farm prices of 1951–55) will mask the effect of rising labor costs in fabrication and distribution. There may be periods of economic recession when the march of hourly wage rates slows up and profit margins are squeezed. But in conditions of prosperity and full employment—which it is the policy and obligation of the Federal Government to maintain so far as possible—we may expect that in general the cost of living will creep irregularly but persistently upward.

The basic problem, as I have said, is a lopsided balance of power in modern collective bargaining. We will live with this problem until we have the wit to diagnose it and the courage to do something about it. In the meantime, we must be careful that in our desire to suppress the consequences of this disbalance of power we do not overwork anti-inflationary policies designed to cope with other problems.

I refer primarily to credit and fiscal policies. These are appropriate for dealing with the kind of price inflation that results from excessive demand for goods and services—from a generally taut and overstrained economy—but it has still to be demonstrated that they can effectively prevent the price consequences of modern collective bargaining without generating worse evils in the process.

Credit and fiscal policies can undoubtedly reduce the bargaining power of unions, but they do so only by slackening the economy itself.

In a slack economy, cost increases are harder to pass on. Management resists wage demands more strenuously, and strikes are harder to win. But how much slack is required to hold wage increases, on the average, to increases in productivity? How large a figure for unemployment does this imply? And what is the price in lost production? More important still, is the maintenance of this degree of slack politically and socially tolerable?

There is another angle to this problem. The last question implies that it is within the power of credit and fiscal management to let the economy down to a certain level—the level at which wage increases average no more than productivity increases—and then to hold it there. No one with the slightest knowledge of economic affairs will believe this. It is simply not in the cards. The danger is ever present that the momentum of the retreat will carry the economy beyond the target level and call for countermeasures, the aftereffects of which will defeat the purpose of the policy.

So long as we have not solved the basic problem of the excessive bargaining power of unions, we will have to "roll with the punches." We will have to accept some degree of inflation as the price of prosperity and growth. A fanatical determination to stabilize the cost of living by credit and fiscal policies, come what may, risks worse evils than it attempts to cure. Until the ax is laid at the root of the tree, we will continue to harvest its bitter fruit.

GEORGE TERBORGH.

UNIVERSITY OF VIRGINIA,
Charlottesville, Va., March 27, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: Attached are my comments on your request of February 17. This has been a most interesting and challenging assignment. I have dealt with the questions with which I am most familiar but passed over the two dealing with the technical aspects of monetary control. The discussion of each question is an attempt to state my views. At times there is some discussion of the matters which received most attention in formulating the view. To fully document each of these matters would probably duplicate much of the work which has already been presented to your committee.

As I worked on the questions it seemed to me that the solutions need to be guided by the ideals formulated by the founders of our Nation and by consideration of our opportunities and obligations as a leader among the nations of the world. There is the constant temptation to substitute techniques for goals. Too, there is much impatience with the effects of a normal adjustment in the Nation's economy which leads to proposals that threaten our basic system of free enterprise.

If there is any way in which I can assist you further in this most important undertaking it will be my pleasure to do so.

Sincerely,

LORIN A. THOMPSON, *Director.*

COMMENTS OF LORIN A. THOMPSON, DIRECTOR, BUREAU OF POPULATION AND ECONOMIC RESEARCH, UNIVERSITY OF VIRGINIA, CHARLOTTESVILLE, VA.

1. Inflation and deflation are measures of change in the ratios of income and prices. Such changes are related to a norm which usually is a period of stability accepted as a point of reference. Inflation occurs when the changes in the ratio of income and prices result in enabling the purchaser to buy fewer goods and services with the same number of dollars as in a previous period. Deflation involves not only the converse of inflation but implies that a decline in prices with reference to income is brought about by imbalance of other factors in the economy.

In a free market changes in the income-price ratio tend to set up secondary causes which in time have the effect of restoring the balance. Thus the high prices of an inflationary period tend first to stimulate production, then to increase costs of materials and labor, and to discourage purchase. In time this chain of cause and effect brings about a state of overproduction which entails a deflationary period of readjustment.

Some sectors of the economy have much greater susceptibility to expansion and decline than others. All sectors do not move in the same direction at any given time. During times of general prosperity, some parts of the economy are often caught in cost-price squeezes with the result that such businesses fail. During periods of business decline (recession and/or depression) some sectors prosper. Sometimes this prosperity means holding their own while other businesses decline.

When the composite result of all economic activity is to reduce purchasing power, many sectors begin liquidation of inventories by reducing prices. This is an effort to change the relationship of prices to income in such a way as to stimulate consumption (buying) which in turn is expected to encourage more production. When inventory liquidation fails to provide the impetus for increased production, further liquidation occurs, with the result that more and more business concerns lose profits or incur losses. In time this leads to an increasing number of business failures, and general loss of confidence. As business confidence is shaken with respect to the need for further production, plant expansion and construction decrease, employment declines, savings are spent for current consumption, and the dollar values of property decrease. If other costs such as labor and interest declined simultaneously, the previous interrelationships of plant, property, labor cost, interest, and other factors would be readjusted to a lower level of dollars, but such relationship would tend to be stabilized.

For many reasons the preceding factors do not adjust themselves automatically, and once a decline sets in, deflation adversely affects those sectors of the economy engaged in production (agriculture, lumbering, mining, construction, and manufacturing). Such services as transportation, business service, and private individuals having high fixed costs and/or long-term contractual obligations are also squeezed as business volume declines. Those sectors of the economy with fixed dollar incomes are in a relatively more favorable position when prices are declining.

Some inflation and deflation is unavoidable. The Nation, if it is to benefit from inventions and discoveries in any field, can do so only by changing, modifying, and at times discarding facilities and methods which have become obsolete or for which there is a diminished need or demand. Much of our present economic difficulty stems from the attempt to undertake new responsibilities without discarding some of the old.

For example, the opportunity for successful agriculture has been diminished by the efforts at acreage and crop control, price guaranties, soil banks, excessive accumulation of surplus commodities, and the like. Such measures, although designed to help the farmer, have for the most part restricted his freedom of choice. Farmers producing crops subject to various controls have been paid by the Government for restricting the acreage. Output has in many instances increased despite acreage restrictions through improved farming practices. Crop support prices have left the Government in the awkward position of having to buy excess farm produce. The Government has in turn built and/or leased warehouse facilities to store more and more crops. Such policies of the Government have reached a point where corrective measures will of necessity be severe and unpopular.

Measures calculated to bring about a comparatively free agricultural market through the reduction and elimination of governmental controls are vigorously opposed on many fronts. Yet a move toward eliminating many of the current control measures over agricultural output appears to be very desirable despite the fact that the consequences of such a change in policy and procedure will adversely affect many. It would seem that rehabilitation measures to assist those adversely affected by agricultural policy changes which would result in a comparatively free agriculture are preferable to a continuation of present policies.

Examples taken from many sectors of the economy would show that governmental policies have become too restrictive in some ways and too lax in others. For example, the concentration of economic power currently exercised by large corporations and nationwide labor unions affects all people and sectors of the economy. The economic fortunes of the American people tend to be governed by the conditions growing out of balance-of-power agreements between big business and big labor. Even though big business and big labor are private organizations, because of their size and strategic position in the total economy, negotiations proceed as though each was a power bloc attempting to seek its own advantage without too much concern for the economy as a whole.

2. Cyclical fluctuations in the economy of the United States reflect the changes in the degree of confidence felt from one time to another with respect to future prospects. Investments for plant expansion or for equipment changes in a plant are made at such times as businessmen feel that added capacity will increase the profits, strengthen the position of the firm among its competitors, or both. If the feeling of management is to the contrary, expansion and conversion are delayed. Subsequent events often differ from the anticipations of business leaders about future prospects. During the last half century in America considerable effort has been directed toward providing built-in stabilizers. The aim of such laws and practices has been to minimize cyclical fluctuations in employment income, expenditures, prices, and credit control. Such mechanisms can be started and stopped more promptly by private enterprise than by public agencies. Among the more important built-in stabilizers are the Federal Reserve System, unemployment-compensation laws, old-age and survivors insurance, other social-security programs, laws regulating the sale and trade of securities, and the FDIC.

Institutional forces, such as government, big business, and big labor, restrict the speed with which adjustments can take place. Greater flexibility in meeting emergencies in the American economy is needed. Some students of such matters believe that bigness in government, labor, and business greatly reduces ability to meet changing circumstances promptly. The suggested cure is limitation of size. Such a policy would affect mergers in business and in labor. It is not altogether clear, however, whether restrictions on size would permit greater flexibility, increase competition, and permit business, labor, agriculture, and other industries to make decisions more promptly than is possible under the present laws. Better understanding of the complex relationship between business and government, if coupled with the determination to ride out small storms without panic, would do much to stabilize conditions.

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3. Others in the group are more competent to discuss the monetary control policies of the Federal Reserve System. The timing of changes in monetary control policies is most often criticized. However, changes in monetary policy, to be most effective, must anticipate developments from 6 months to 2 years in advance. If the Federal Reserve Board acted this far in advance it would be subjected to the criticism of attempting to influence unduly the direction of the Nation's economy by inaugurating changes which were not justified. The recurring problem is to determine when bold and decisive action is required, and when deliberation and delay may be wiser. In this respect hindsight is always better than foresight. So long as those charged with the enactment of laws—their administration and enforcement, together with leaders of business and labor, act in good faith, reasonably prompt adjustment to worsening economic conditions is possible.

4. Many factors have contributed to the decline in the value of the dollar and a continuing increase in the Consumer Price Index since August 1956. Employment in 1956 first leveled off, then declined. Output in many industries has been reduced and unit costs of production have increased. The increase in general productivity which normally results from increased labor efficiency does not appear to have occurred during the last 2 years. Price increases have been made wherever possible to cover increasing production costs due to decreased volume and higher wages. Such developments are due in part, but not exclusively, to surplus productive capacity. Steel output, for example, is about 50 percent of capacity as of March 1958. The steel industry expanded during the years of World War II and thereafter so that the Nation could meet more adequately defense and consumer demand. A sharp drop in total demand, such as currently prevails, places the steel industry in the position of having to carry the costs of keeping its facilities and plant in readiness to meet any increases in total demand that occur. Reserve capacity in basic industries in generally regarded as desirable and necessary, there can be little doubt about the fact that during periods of relatively low demand, the costs of maintaining idle facilities increases production costs and decreases the prospect of profits. The break-even point (the percentage of capacity which must be used to meet all expenses) is much higher now than prior to World War II. This is true of many other industries also.

For this reason, sharp declines in demand, if sustained for any considerable period, can spread to many other sectors of the economy until the total economy functions at a lower level of output and consumption than formerly. A lower level of output and consumption means a declining standard of living, business failures, bankruptcy, increasing unemployment, and hard times. If the economic apparatus can continue to function, even at a somewhat reduced level of activity, readjustment can proceed with a minimum of trouble.

Increased sales effort has been used as one of the means of reducing inventories and of stimulating production. While retail sales have been extraordinarily good during the last several months, merchants generally have been reducing inventories wherever possible and limiting forward buying. This in turn has curtailed employment in manufacturing and transportation industries more than distribution and service. If sales are pushed unduly, as they were in the automobile in-

dustry in 1955, a decline in subsequent years may follow until the demand has increased sufficiently to again stimulate production. Overselling, which is most difficult to define, but whose meaning is generally clear, has not resulted in balancing the demand for goods with the supply available. The high level of production, on the other hand, has tended to reduce the amount of price increase. The foregoing, along with other factors, have continued the wage-price spiral during the recent period of declining output and increased unemployment. If current conditions were left alone, it is probably that the recent decline in the dollar value would be arrested. As a matter of fact it might improve. Tinkering, especially when attempting under pressure, can often do more harm than good.

5. There are many indications that the United States uses public debt as a means of expanding its price and credit structure. The Federal public debt currently is equal to about 63 percent of the gross national product. A part of the income of many business concerns and individuals is invested in United States Government securities. If the debt were reduced these funds would seek other investment outlets. Reduction of the Federal public debt at the present time would mean the curtailment of expenditures for national defense. There are interesting parallels in the level of defense expenditures in the United States, rates of productivity of industry, income levels, and mass purchasing power.

Since 1940, particularly, defense and war expenditures have led to an expansion of industrial capacity. Much of the increased output during the period from 1941 to 1945 was for war and national defense. The Government was the purchaser; industry the producer. The increased material requirements of the Government provided the basis for the enlargement and expansion of the industrial establishment. Funds paid to the Government were in turn spent for war material and for greatly augmented Armed Forces personnel. When military demands relaxed and members of the Armed Forces returned to civilian life, the output of the Nation's production establishments was channeled in the direction of satisfying civilian requirements. By 1950 many of the pent-up demands of civilians had been met and the size of the Military Establishment drastically reduced. With the outbreak of the Korean conflict the equipment, materiel, and personnel of the Armed Forces were again expanded. Curtailments since the end of the Korean conflict have been comparatively small.

The race with Russia for military supremacy and the developments in the field of atomic warfare and missiles have altered the nature of the United States Defense Establishment, rendering earlier weapons obsolete. The increased emphasis on scientific research and development will result in more rapid obsolescence of equipment and weapons which only a few years ago were thought to be effective. So long as the United States and other world powers feel it necessary to maintain and develop increasingly powerful and effective weapons of mass destruction and warfare, the prospect for reducing the Federal debt will be dim. If world conditions worsen, defense expenditures will be increased and this in turn will exert further pressure on wages and prices. A peaceful world, in which military requirements can be vastly reduced, offers the best hope of a more stable economy.

If it becomes possible to reduce substantially the outlays for national defense, there is little doubt that some serious deflationary readjustment would follow. This will be a small price, however, to pay for world peace, particularly if appropriate measures are taken to assist in relocating and retaining those persons whose jobs vanish as defense establishments close. The chance for this sort of readjustment appears, at the moment, to be very remote.

6. (*a*) Price stability is attained when costs of raw materials, production, and labor remain stable. To the extent that productivity increases somewhat faster than demand, there is an opportunity to reduce costs, increase wages, and stimulate demand. When these factors are in balance, technological improvement results in increasing the benefits throughout the entire economy. When technological improvements result in increased costs, such developments can temporarily reduce employment, demand, and real incomes. Price stability is accomplished only when the cost of production, demand, and purchasing power remain in balance. The price level at any given time results from the interaction of many factors and, in a competitive market, tends to regulate itself.

(*b*) Since World War II production, demand, and employment have increased. A part of this change reflected the pent-up demand which accumulated during the war years. Following the termination of the war and the removal of rationing and price controls, this pent-up demand gave the impetus for expanding production and employment, and triggered the ensuing wage-price spirals. Population growth and increase in mass purchasing power further stimulated production and employment. During 1949 and 1950, and again in 1954, production outstripped the demand for certain goods and services with the result that brief recessions occurred. Since 1954 world conditions have been such as to discourage any reduction in armaments. The demand for civilian goods has been maintained at a good level; it has not continuously equaled productive capacity. The result has been a decline in the rate of growth of many industries. For example, the boom in babies which began prior to World War II and continued at an accelerated pace at the conclusion of the war has increased the demand for educational facilities, housing facilities, recreation, food, clothing, and many other goods and services. The growing segment of the population 65 years of age and over has increased the need for special facilities and accommodations for this sector of the population. Since the war the labor force has not expanded as rapidly as the older and younger sectors of the population with the result that an increased proportion of women have entered the labor force and have contributed in an important way to the purchasing power of family units. In another decade, when the present large youth population enters the labor force, employment opportunities will need to be expanded more rapidly than they have since World War II, if the same proportion of the population 20 to 64 is to be employed.

7. As pointed out previously the high level of Federal spending, particularly on armaments and devices connected with national security, has underwritten a considerable segment of our economy. Moreover obsolescence has been rapid. The result has been the production of many goods and services that have little utility. Spending

does provide opportunities for the investment of capital, for expanding employment, and these in turn result in expansion of wages and salaries, and profits.

State and local governments in recent years have been confronted with rapidly expanding demands for a variety of public services. The boom in babies has created a need for more schools and more teachers at better salaries. Growing metropolitan areas have found it necessary to increase their expenditures for more and better roads, increased parking facilities, new and enlarged water systems, sanitary facilities, public health, to mention but a few of the expanding demands. The expenditure of State and local governmental funds results in more long-term benefits to peacetime life than the Federal expenditures for national defense. The outlays for school buildings, water systems, sanitary facilities, and roads stimulate all industries which produce the goods necessary to construct, equip, and operate such facilities and establishments. Such obligations which are currently a part of the State and local government lead to a consideration of taxation.

8. The effect of taxation on our economy is complex and involved. The revenue requirements of the Federal, State, and local governments determine the amount of taxes needed. The subjects of taxation employed by the three levels of government overlap. The increasing interest centers around the rates of taxation imposed on the many subjects taxed. Local governments are to a large extent dependent upon the taxation of property. Taxing wealth per se is unpopular. Taxation of earnings, income, gross receipts, and sales finds more popular support. Perhaps the most critical problem of taxation is the extent to which the total tax bill—that is, State, Federal, and local taxes siphons off a substantial part of the proceeds of business and the earnings of individuals. Tax revenues, however, are spent by governments for goods and services and, as pointed out above, stimulate the economy just as definitely as though the funds were spent by private enterprise and individuals.

It is largely a question of how the Nation wishes to finance and provide for the many services that it has come to expect of government. If we want national defense, we must pay for it, and since the only government capable of protecting the Nation is the Federal Government, it follows that there must be Federal taxation to meet these needs. Since it is customary for local governments to provide for water, sanitation, streets, fire and police protection, and general government, local governments must find the revenues to maintain such services. Education, public health, and welfare are areas in which there are joint operations. Some of the programs are jointly financed by the Federal, State, and local governments; others, such as public education, are mainly financed by a cooperative arrangement of State and local governments.

One of the controversial areas of taxation is the progressive income tax. It is argued that such a tax discourages initiative since the more one makes, the larger the proportion of earnings is paid as a tax. It is most difficult to determine whether the very high rates on large incomes deter individuals from participating fully in economic affairs. It seems quite clear, however, that the generally high level of Federal taxes has (1) provided much of the money needed for the construction,

maintenance, and operation of many private businesses; (2) expanded employment and mass purchasing power; (3) absorbed a substantial portion of price and wage increases which in turn have provided more funds for Federal activities.

Federal spending, most of which has been and is for national defense and defense-related obligations, has contributed to the expansion of the Nation's economy. Since the Federal Government must tax individuals and businesses for its revenue, a part of current tax revenue goes for the expansion of plant, equipment, and facilities. Thus the amount of Government spending at any given time affects total spending. A part of total industrial production depends on Government purchases and contracts. If Government purchases and spending are curtailed at times when other buyers (private business, exports, etc.) are not in a position to absorb the output, business fails, unemployment increases, investments go sour, and confidence collapses. Thus tax cuts, especially if the final effect is to decrease public revenues, impairs the ability of governments to influence the level of economic activity. If government is to participate less in total economy, private enterprise must do more and be able to absorb the costs, employment, investment, and other obligations which governments have discharged. As matters stand now (March 1958) if Government spending were sharply reduced, unemployment would increase further, the number of business failures would accelerate, security markets would fall, and general confidence would be impaired.

The appropriate time to reduce governmental participation in the economy is during a period of prosperity. If governmental spending drops during periods of economic stress the results are likely to be severe and generally damaging.

9. Fiscal policy is a means toward many ends. Since the end results expected of fiscal policy are diverse and extensive, the goals and objectives of fiscal policy often appear to conflict. For example, higher interest rates on Government bonds increase the share of total revenue for debt service, lower interest rates conversely decrease the cost of debt service and can exert some influence on other interest rates. Congress, in having the constitutional authority to coin money and regulate the value thereof, is in a position to influence interest rates. It is not always clear whether interest rates are means or ends in themselves. The bases for determining this matter are complex and obscure.

Fiscal policies have been and are used as controls over other objectives. Within the past 2 years, higher interest rates and tight lending policies are believed by some to have throttled building activities and plant expansion. Increased interest rates alone could scarcely be expected to be the decisive factor. Borrowers have hesitated for other reasons, such as the relative advantages of building now as compared to some later time. Government fiscal policy, since it does affect so many facets of the life of individuals and business, should aim toward stability in the whole economy so far as possible. Bad timing of public-works programs has frequently resulted in giving a push to the wage-price spiral. At other times, such as the present, Government is not ready to begin large-scale public-works programs promptly enough to provide jobs for the unemployed. Advance preparation is difficult to schedule so that it will coincide with turning points of the business cycle.

The most important requirement of Government fiscal policy is that it promote the long-term interests of all the people in the Nation. If, for example, more money is necessary for national defense than is currently available, then fiscal policies and procedures should promote this objective. If, on the other hand, less money is needed, fiscal policies should be readjusted toward this end. The Federal budget must adjust expenditure requirements to revenues. In the process of allocating funds it is often difficult to draw the line between essential and desirable, but less essential, programs. Principles, when considered apart from their application, seem clear. Application of a principle to a set of circumstances is frequently involved and complex because one action influences so many others. There is the continuing hazard of deciding matters on the basis of principles without due consideration to the circumstances and limitations under which they must function. This viewpoint means that, before changes in existing policies are made, the alternative proposed must offer general all-around improvement. On the other hand, if a change of policy or procedure offers distinct advantages, no hesitancy in trying it seems justified.

The need in America is for an appraisal of all governmental activities in relation to the needs of our time and of the future. More concern should be given to such questions as:

(1) What functions and services is it necessary and desirable for each level of Government to perform?

(2) Which activities should be undertaken on a joint and cooperative basis?

(3) What activities now performed by Government could or should be carried out by private enterprise and under what conditions?

Studies and reports have been made on many of these matters but action has been slow and hesitant. Continuous appraisal and examination is essential if the activities and programs of Federal, State, and local governments are to serve the people. Rigidity and cumbersomeness in Government fosters and promotes inefficiency, waste, and entrenchment.

Fiscal policies of Government can be improved as the purposes of Government itself can be more clearly defined in relation to the times in which we live. Until the objectives of our domestic and foreign policies are more clearly set forth, monetary practice will continue to be more a matter of complex and skillful juggling than an instrument of national policy.

10. Others are more competent to discuss this question.

11. (*a*) Inflation (higher prices) often parallels increases in unemployment. This occurs when current unit production costs increase as the volume of output declines. Current price levels reflect financial commitments made by companies from 6 months to 5 or more years earlier. Such commitments were made in anticipation of the future. When the future of a former period becomes the present and differs from expectations, seeming paradoxes occur such as inflation and increased unemployment. If such developments are regarded as episodes in a longer adjustment cycle, the forces at work will readjust themselves and bring about a new balance. The debate usually centers about the desirability of some form of intervention which is expected

to alter and/or restore the former balance of forces in the economy. The problem is similar to that which confronts a physician with a patient whose state of health appears to be less satisfactory than at a previous examination. Do the results of the present examination and current symptoms suggest surgical, or some other kind of intervention, or should nature be allowed to run its course? In the field of medicine, radical procedures, of which surgery is one, are undertaken only when the probability of beneficial results is good, or when delays might jeopardize the prospect of recovery.

The American economy on the whole as of March 1958, is not as robust as at earlier periods. The current symptoms of unemployment and inflation will adjust themselves. The question is whether loosening of credit, tax cuts, extension of unemployment benefits and many other proposals will increase the vigor of the economy for the long pull, or whether such measures at best would serve only as temporary palliatives. In this writer's view productive capacity has been expanded beyond the point of meeting the consumer's usual demand for products and service. Such commodities as automobiles, refrigerators, washing machines, and television sets, to mention but a few, depend upon early replacement of such equipment by the consumer through obsolence and style change. The elasticity of consumer demand for this reason is much greater than would be the case otherwise. Thus purchases made this year reduce the prospect of sales next year, and the consumer's decision to postpone the replacement of old equipment, or the purchase of new, threatens at all times the stability of supply and demand. American industries, by and large, have a considerable amount of reserve capacity. Such a reserve has many advantages, but it has the disadvantage that a decline in consumer purchasing will often increase production costs by reducing output, and result temporarily in lowered profits, or losses. This is the process of readjustment which is to be expected in a relatively free market and economy. The alternative of elaborate controls calculated to minimize fluctuations in output and supply is oppressive, cumbersome, and expensive. It is doubtful whether such elaborate controls are ever necessary to regulate all facets of the economy. In the writer's view more elaborate controls are not justified now. As a matter of long-term policy many of our current policies and procedures need to be simplified and streamlined.

(*b*) Inflationary trends have been supported to a considerable extent by the expanding level of private and public debt. If the ratio of total debt to personal income increases, the opportuntties for investment are expanded. In the past a substantial part of investments have been used to expand plant, machinery, and equipment. Such investments are made with the expectation that unit costs of production will be relatively more favorable, and/or that market demand will increase. The dilemma of the American economy is that no certain guides exist for determining how much or how little capital expansion should be undertaken at any given time. Perhaps scheduling of capital expansion for 6 to 10 years in advance would help some. It would assist the construction and building materials industries to stabilize their output and employment. Considerable elasticity in this sector of the economy is perhaps inevitable, but it seems quite unnecessary for these industries to operate on a boom and bust basis.

A gradual inflationary trend is not necessarily essential to the growth and development of the Nation's economy. As suggested in question 1, inflation is brought about by disparities in the ratio of prices to income in different sectors of the economy. When one sector advances at the expense of another internal pressures are built up which seek to restore the relationship of some previous period. Wage increases are followed by price increases, or vice versa. Such wage-price spirals impair the income and purchasing power of annuitants, pensioners, and of all persons and institutions whose incomes are derived from bonds and/or mortgages. This results in some transfer of investment funds into channels in which earnings from investment have a more attractive relationship to current prices. Such pressures become inflationary when output and consumption are high. If consumption for any reason declines and continues below productive capacity for any considerable period the general effect is deflationary. If such a readjustment is met with measures calculated to increase purchasing, production, employment, and relative total debt, and if such measures are successful, then another round of inflation begins. The Nation has been going through this cycle periodically since 1939.

It may well be that a gradual inflationary trend is the price that the Nation must pay in order to maintain its position as a world power. Developments since the end of World War II strongly suggest this. People differ sharply as to the need for such a high level of governmental expenditures. The level of such expenditures has been so high for so long that a sharp and sudden reduction in governmental outlays would throw the whole economy into a tailspin. Reductions should be gradual and spread over a long enough period to permit the private sectors of the economy to readjust if we are satisfied with the amount and kind of national security such a policy will buy.

12. The growth of private debt in the American economy during recent years has contributed to fluctuations in production, employment, and to changes in the pattern of spending. In 1950 individual private debt was equal to about 48 percent of personal income payments, and increased steadily to about 64 percent in 1956. Such a change increases the amount of current income which goes for debt service for private individuals and business. More than 60 percent of the private debt is for home mortgages. In the housing field, the alternative to homeownership and debt is rent, hence the increase in mortgage debt has some advantages for the borrower. As individual buyers incur additional debts, including mortgages, the amount available for other purchases decreases. If the consumer elects or is obliged to restrict his purchases for lack of credit, inventories accumulate and eventually production and employment decline. In a sense we are paying today for goods bought yesterday, and as a result can buy less today. Those who have lost their jobs due to cutbacks in production can buy even less.

There is little doubt that the contraction of consumer credit would work a hardship on many sectors of the economy and this would be deflationary for the period during which consumer loans were being liquidated. If the economy survived such measures it would be stronger for the long pull. This suggests that much of our recent eco-

nomic expansion has been based on the expectation of gradual inflation which in turn has encouraged an expansion of lending and borrowing. If the price-income ratio were to remain stable or decline somewhat, individual borrowing, which anticipates inflation or increases in value, would tend to be curtailed somewhat. It appears that further increases of private debt in relation to personal income should not be encouraged.

Debt, whether it be public or private, in the long run has similar effects on the economy. The size of the total public and private debt in relation to income and production have not changed greatly over the last half century. During the last decade there have been many pressures which indicate that this historic ratio may increase. Lending policies that are increasingly liberal tend to increase the dependence of the whole economy on credit expansion and this is an inflationary force. On the other hand, if credit were restricted and sharply curtailed the result would be deflationary and would undermine many established credit businesses in our economy. The major problem appears to be one of keeping the credit within bounds and such decisions in the last analysis depend upon the decisions of lending institutions when applications for loans are made.

13. One of the major shortcomings of Federal policy for many years is the fact that it has never been prepared to deal promptly with large increases in unemployment which accompany decreases in consumer demand and production. At present the people in distress are those who have lost their jobs and have no current source of income. Many of these people have been helped for a while by unemployment compensation benefits. Such benefits, of course, soon exhaust themselves and unless the worker can find another job he is without any source of income. Such proposals as income tax cuts will in no way benefit these people who have already lost their eligibility to pay such taxes. Income tax cuts at this time would benefit only those who have such tax liabilities and would do little to help the unemployed. Furthermore, such activities as public works programs cannot be started overnight. The most that can be hoped for is that the dates for commencing such projects which are ready be advanced. Accelerating the planning of public works and moving to the point where they can be let for bid will provide for an expansion of employment some months hence. Only those which can be commenced without delay will meet immediate needs for absorption of the unemployed.

Increasing unemployment is a special kind of emergency. In many respects it does not differ from floods, drought, or the catastrophes of war. If progress is to be made attention must be centered on those sectors of the economy that need help now. This means that such measures as the extension of unemployment benefits for those who have used their benefits be made now. Increased appropriations for direct relief for those who are jobless would carry these people until they can return to work. Meanwhile those sectors of the economy which are not in trouble require no attention at this time. Relief funds, if appropriated promptly to local governments, could in many instances be used for local cleanup and beautification projects which can be organized fairly promptly. To the extent that the person in need of relief money can render some service in exchange for the

grant, his self-respect is maintained and the public gets some benefit from the money spent in addition to relieving the distress of the individual.

Such proposals as increased Federal spending and tax reduction at the same time make little sense. All that could hope to be accomplished is to postpone the day of reckoning and encourage continued inflation. Such a policy does not auger well for the domestic economy and places the United States in an increasingly difficult position in the matter of foreign trade. Debt, however acquired, must be paid in one way or another. One of the ways in which we have been managing public and private debt is through inflation. It seems pertinent at this point to examine critically any proposal which would deliberately foster further inflation. Such action should be taken only as a last resort.

14. Deficit spending by the Federal Government since the end of World War II has contributed to inflation by indirectly encouraging more expansion in the private sectors of the economy than would have been likely otherwise. There has been a disposition on the part of many people to accept the notion that man's wants are unlimited and for this reason there is no such thing as overcapacity, or overproduction. While one may admit that perhaps man's wants are unlimited his ability to use the services and appliances reflected by these wants is indeed limited. In a practical sense then, there is some limit to the number of automobiles that can be produced, sold, and driven. Similar circumstances are also true of other types of commodities. Thus if production and capacity are expanded too much faster than current rates of use, sooner or later dislocation occurs. It may be that too many television sets were sold last year so that it becomes more difficult to sell them this year. Within a year or two this situation will adjust itself. Tinkering with the production and distribution requirements cannot be expected to exert great influence over the basic relationship of supply and demand.

For some months plans for the expansion of plants and facilities among many private corporations have been modified. A general reassessment of the time at which such additional facilities will be needed is taking place. The result is that additional construction of new facilities for manufacturing and distribution industries has slowed down. There appears to be a need for a period of adjustment for the whole economy. The most urgent problem is relief for the unemployed and this should be dealt with directly rather than indirectly. If the unemployment emergency is handled as a relief problem there will be less need to attempt other hastly and ill-considered measures.

15. Full employment can be attained without reducing the purchasing power of the dollar if one allows for some flexibility in the definition of full. Some flexibility in the interpretation of the meaning of full employment is essential, otherwise the concept becomes arbitrary and unrelated to the circumstances under which individuals must live. This interpretation implies that employment to be full, may need to be shared during periods of decreasing demand. Reduced output has usually been used to prune the less efficient and effective workers. These have been dropped and become unemployed, while the more efficient and those who have seniority stay on and re-

main fully employed. If shared employment during periods of declining demand were more widely used by both industry and labor the demands made on Government for relief of unemployment would be less. The procedure in our society has been to shift misfortune and burdensome matters from one sector to another whenever possible. As unemployment increases the needs of the unemployed are met one way or another. To the extent that business is unable to continue the worker in employment, the burden is shifted to the community which means to some level of government. To accept this responsibility the Government must in turn tax business and individuals to provide the funds to underwrite this particular risk. If widespread employment is not met by Government it must be met by private individuals who help one another or who raise funds for various charitable purposes. However we look at unemployment, the more fortunate must provide for the less fortunate in some way or other during times of distress.

The way in which unemployment is dealt with can make considerable difference to the economy as a whole. The more elaborate the procedures for dealing with temporary and cyclical emergencies, the more involved and expensive the program becomes. The ability of the Nation to fulfill the goals set forth in the Full Employment Act of 1946 calls for prudent and effective management of temporary and emergency conditions.

16. Escalator provisions in wage and other contracts are not necessarily incompatible with economic stability. To a very considerable extent escalator provisions are designed to promote economic stability and to provide an incentive for increased productivity. The escalator provision in wage and salary contracts is based on the assumption that the purchasing power of workers will be more stable if wage levels are adjusted periodically to changes in the cost-of-living index. Such provisions have worked in the interest of stability. Business and industry so far as possible attempt to negotiate long-term purchase contracts at stable prices. The purpose of contractual obligations and escalator clauses is similar in that each attempts to preserve for some period in the future the same relationship between cost, price, and profit that has prevailed in a pervious period. Circumstances often develop which increase the difficulty of maintaining these relationships. Escalator provisions, like many other tools, must be used wisely if they are to make their full contribution toward economic stability. If the provisions in such contracts are unreasonable or the administration of the contracts is unwise, escalator provisions can be troublesome.

17. The causes of the present recession are somewhat obscure and not fully understood despite the fact that there are many current diagnoses of our situation. And there have been many proposed cures. It is one thing to identify what appear to be the main forces and institutions which affect our economic fortunes from one time to another and quite another to know how to manage these institutions in such a way as to promote maximum stability at all times. It is in this latter field that our methods and practices are perhaps not as well understood as in the matter of identifying forces and institutions. A management policy which seemed appropriate at the time it was made may prove to have been a mistake later. Perhaps an

illustration may help. A loan should benefit the borrower, the lender, and in a more remote way, the public. These three basic conditions must be satisfied for a sound loan and for sound use of credit generally. While there is some latitude as to what may constitute soundness it is unlikely that the manipulation of reserve requirements or interest rates will alter these basic considerations. Boosting reserve requirements and scrutinizing loans will act to curtail credit and such measures are justified when the practices of lending institutions are governed more by general regulations than by the essential objectives of sound credit. In short, the purpose of regulatory credit machinery is to reduce or limit abuses and not to obstruct the sound use of credit.

While it may appear a little trite perhaps the most important cause of the present recession has been the vigorous race for supremacy between competing businesses during the past decade. This has resulted in overextensions of productive capacity, and to vigorous high-pressure sales campaigns which have encouraged the consumer to buy more and more things. To promote sales and production goals consumer credit facilities have been expanded to enable the consumer to buy now and pay later or to pay as he uses. So long as the rate of activity in all of these arrangements continues at the same level or at an increasing level, everybody prospers. The mechanism, however, is so delicately balanced that a drop in consumer demand can back up all the way to the producer of the raw materials. What this actually means is that if total consumer demand is miscalculated even vigorous and frantic sales efforts may be unsuccessful in moving inventories. The economy cannot go forward until demand, production, and sales are brought into a better state of balance. Such fluctuations have occurred in the past and should not be considered as unusual now. The primary needs at the present time to curb the inroads of the recession are measures which will directly benefit the unemployed and those in need, and to defer any consideration of measures which would modify the ground rules under which our economic system has been operating. Certainly any changes in the ground rules should be fully and carefully considered before adopted.

YALE UNIVERSITY,
DEPARTMENT OF ECONOMICS,
COWLES FOUNDATION FOR RESEARCH IN ECONOMICS,
New Haven, Conn., February 25, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

MY DEAR SENATOR: Thank you for your letter of February 17 inviting my views regarding the financial condition of the Uinted States. I am sorry that I do not have the time or competence to answer all the questions you have put. On many of the questions of policy I do not have firm opinions; on many of the questions of fact and diagnosis I fear that our knowledge leaves the answers still uncertain. It would therefore take a very long essay indeed to give not only answers to the questions but also the reasoning behind the answers and the qualifications and uncertainties with which they should be hedged.

I will therefore confine myself to stating certain personal convictions on the key issues your questions raise, without being able to explain the reasons that have led me to them.

1. Price stability is a proper and important goal of economic policy, but it is not the only goal. It should not be pursued as an absolute, regardless of the cost in terms of other objectives. Full employment and economic growth are also important objectives, and some balance must be struck between these goals and the prevention of inflation. In my opinion, both Federal Reserve policy and fiscal policy have in the past 2 years been too greatly dominated by fear of inflation. It is for this reason that the Federal Reserve has been so late and so cautious in easing money, even though the signs of a slackened growth rate and a coming recession have long been apparent. It is for this reason that the budgetary policy of the administration is still directed toward limiting Federal expenditures and balancing the budget. I find the social costs of this quest for price stability too great. We are wasting our resources and our potentials for growth at a time when compelling international and domestic needs remain unsatisfied. I am not sure that the sources of recent rises in consumer prices are vulnerable to fiscal and monetary policies, unless the economy is made to suffer prolonged and substantial unemployment and excess capacity. These sources are partly the cost-push due to wage pressures, partly the delayed adjustment of some fairly sticky wages and salaries, utility rates, rents, and prices of services to the earlier postwar inflation, partly the reversal of the decline in agricultural prices. In order to prevent the obvious evils and inequities of inflation from having an undue weight in the formation of Government economic policy, I favor the institution of inflation hedges to protect the mass of small savers who are now, through lack of means or knowledge, too vulnerable to changes in the purchasing power of the dollar. The Government should offer bonds with purchasing

power guaranties; and variable annuities should be available to purchasers of life insurance.

2. In my view, deficit spending is now called for to get us out of the recession. I fear that the Federal Reserve has waited too long; business prospects have deteriorated beyond their control. The fringe of unsatisfied borrowers who would have gladly responded to an easier money policy 6 months earlier has now evaporated. The job is now one for fiscal policy rather than monetary policy. The needed deficit spending could be accomplished either by a tax reduction or by increased expenditure. I believe that a tax reduction would be a wasteful way of employing the labor and capacity the recession has made idle. The added consumption a tax cut would stimulate is of much lower priority, in terms of national need, than increased public expenditure for defense, education, highway construction, and other purposes. I do not favor make-work schemes of expenditure, but rather the immediate adoption of expenditure programs that could claim a high priority for resources even if we had no recession. Indeed at a later date, when the recession is conquered, it may be necessary to increase taxes in order to sustain these important programs without causing inflationary pressure.

Cordially,

JAMES TOBIN, *Sterling Professor of Economics.*

YALE UNIVERSITY,
DEPARTMENT OF ECONOMICS,
New Haven, Conn., April 10, 1958.

Hon. HARRY F. BYRD,
Chairman, Senate Committee on Finance,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: In response to your letter and questionnaire of February 17, I am giving you my views on some of the points raised.

All of the questions strike me as important, but many of them are very broad. On quite a few, the discussion has already jelled into fairly standardized patterns. In such instances, all one can really do is to register one's vote on the issue, without much hope of contributing a new idea.

Question 2. To improve our anticyclical policy, I would suggest the following:

(*a*) Provide some flexibility in withholding taxes, at the discretion of the President, for limited periods, say up to 6 months. Extensions of tax cuts beyond this ought to be subject to congressional action.

(*b*) Excise taxes might be made flexible and subject to the President's discretion. This might be particularly effective in periods of inflation, because the expectation that excise taxes may be cut causes people to delay their purchases, as we are seeing right now. An increase in excise taxes during inflation might have a powerful anti-inflationary effect, although it would temporarily distort the cost-of-living index.

(*c*) Price stability as an objective of policy might be written into the Full Employment Act.

(*d*) The advisability and fairness of subjecting industrywide labor unions to the antitrust laws might be studied.

Question 3. The Federal Reserve on the whole has done a very good job. In the preaccord period they might have struggled a little harder to get away from Treasury control a little earlier. Their fears that the bond market might collapse if credit controls were applied now appear to have been exaggerated.

In the postaccord period, I think the Federal Reserve did a good job in meeting the recession beginning in 1953. In the 1957 recession they probably overstayed their market.

The lessons of recent Federal Reserve experience I would summarize as follows:

(*a*) The effectiveness of Federal Reserve policy has perhaps come to be overrated since 1953, because of their relatively easy successes under favorable conditions.

(*b*) The absence of overall coordination of credit policy, including FHA, VA, CCC, etc., has become quite noticeable. I would hesitate to suggest some sort of monetary council, however, if that should lead to a serious abridgement of Federal Reserve independence.

(*c*) The evidence suggests that Federal Reserve restraint falls rather heavily upon investment, as against consumption. The result is to restrain growth. Flexible fiscal policy works mainly on consumption, rather than investment. If inflation restraint could be exercised more predominantly through fiscal policy we would probably get more growth. But before reducing the role of monetary policy, I would like to be quite sure that fiscal policy has really been placed on an efficient anticyclical basis, with adequate flexibility. At present, we have nothing of the sort.

(*d*) Recent evidence also suggests that monetary policy falls with disproportionate weight upon small business and upon municipalities. This evidence, however, ought to be studied more carefully before it is used in drawing conclusions as to the usefulness of monetary policy.

(*e*) Regulation of consumer credit and housing credit may become desirable if boom conditions such as experienced in 1955 should recur. It is particularly important that credit terms be tightened and shortened in good times so that in bad times we have something to relax. In our present recession, we are handicapped by the fact that automobile installment terms are already so long that they can scarcely be lengthened.

Question 4. The present inflation, in my opinion, was caused more by the action of labor and business in raising wages and prices than by excessive consumer demand for excessive money supply. As between labor and business, I believe that the main responsibility for inflation belongs to labor for two reasons:

(*a*) Profit margins of business have been shrinking rather than expanding recently. Business, in raising prices, usually has done no more than try to maintain profit margins. Labor, on the other hand, has demanded and obtained wages in excess of productivity gains.

(*b*) Labor, with a total share in the national income of about $220 billion, is much larger a factor than business with its profits (corporate and unincorporated) of about $70 billion. From 1950 to 1955, for instance, compensation of employees increased by $67 billion or 43 percent. Of this amount probably less than $30 billion (an increase of 20 percent) can be attributed to productivity gains. Inflationary wage demands of this magnitude would eat up the large part of profits in a few years, supposing business did not raise prices. Evidently such wage increases cannot go on indefinitely without inflation, even if business were disposed to sacrifice all profits.

Question 5. The importance of the national debt has been greatly overrated so long as the debt is competently managed. By that I mean an effort to maintain its maturity structure, avoid pegging of bonds by the Federal Reserve, and an obligation for the Treasury to pay the rates demanded by the market. If the debt is managed by reliance on Federal Reserve support it will most probably contribute to inflation, as it did before 1951. A very much smaller debt, however, equally mismanaged, would have the same effect. Although I see no objection to occasional increases in the debt as a result of antirecession policy, I would argue that in good times we should pay it off as a means of increasing capital formation. So long as the economy functions at full employment, the paidoff security holders will have

to look for new investment outlets which will stimulate the growth of the economy.

Question 6. In the long run there is probably no serious conflict between stability of prices and economic growth. In the short run growth usually could be accelerated by inflationary policies. Assuming we were willing to pay this price, it would still remain doubtful how long the beneficial effects on growth would continue without being nullified by the adverse impact of inflation on saving, investment decisions, and productivity. The amount of inflation that we could "get away with" is probably less today than it has been in the past, because everybody has become conscious of inflation. The adverse effects, therefore, are likely to follow more quickly nowadays.

Question 7. I believe that Federal spending for a good many purposes today is too low. Among these I would include education, health, social security, cultural affairs, research, roads, parks and bridges. Federal spending strikes me as too high for agriculture, veterans, and rivers- and harbors-type projects.

In general, I believe that our standard of living has reached a point where the consumer can get more value in many cases for a dollar spent by the Government than for a dollar spent for himself. I base this upon my relative appreciation of education, research, health, and cultural projects, as against tail fins, TV's, and soft drinks.

Question 8. I would like to see certain reforms in our Federal tax structure, such as cuts in the personal and corporate income tax and a broadening of excises to make up the loss of revenue. On the whole, however, I think that our present taxes are not too difficult to live with. While they damage incentives and distort the use of resources, the damage probably is not overwhelming. Thirty years ago, the present tax system might have raised havoc, but meanwhile we have largely adjusted to it.

Many people greatly overestimate the effective burden of income taxes. A 20-percent effective rate does not apply, for a couple with 2 children and 10-percent deduction, until well above $20,000.

I would not want these general observations understood as arguing against a reform of our tax system as soon as possible, however, along the lines suggested at the beginning of this question.

Question 11. (*b*) A little inflation, in limited doses, is probably beneficial to growth and employment, as I have argued under question 6. Whether the chances of achieving the right dose are good enough to warrant making this a goal of policy seems quite doubtful to me. In practice I would, therefore, aim at price stability as the goal. I would argue for this even if it meant a somewhat lower rate of growth and a somewhat higher rate of unemployment, because permanent inflation strikes me as unethical and incompatible with a healthy social structure.

At the same time, it is obvious that the conflict of price stability on one side and full employment and growth on the other may be very serious. Depending on the behavior mainly of organized labor it may take so large an amount of unemplyment as to make the pursuit of price stability politically impossible. If, as I fear, that is our present situation I would suggest legislation along the lines suggested in my reply to question 2.

Question 12. Someone who believes in saving cannot be consistently opposed to debt. The savings must be borrowed if the economy is to remain stable. It is quite possible, however, that housing credit and consumer credit may have gotten out of hand in recent years. A tendency for corporations to overborrow may flow from the corporate tax structure.

I do not think that conditions in these fields are serious today, although a prolonged and deep recession might put a different face on this judgment. For anticyclical reasons, I would like to see some tightening of consumer and housing credit, as indicated under question 3.

Question 13. The answer seems to me to depend on the degree of inflationary danger. In the absence of such danger I would favor prompt action to bolster overall demand, but not to prop up weak industries that are in a long-term downtrend, such as agriculture and textiles.

Question 15. See answer 11 (*b*).

Question 16. Escalator contracts may be a serious threat to stability. A study should be made to get at the true range of effectiveness. Basically, however, they are a symptom more than a cause of inflation, and the proper cure is to stop inflation.

Question 17. With regard to action against the recession, I would suggest a suspension of the withholding tax for a month or 5 weeks, if there are no clear signs that the recession is bottoming out by the end of April. A tax holiday of this sort would give the economy a quick shot in the arm and help to clean out topheavy inventories. It would not give away revenues permanently, as a permanent tax cut would. The results of the action could be observed almost immediately, again in contrast with a smaller but longer tax cut. A year-end adjustment would have to be made so that all taxpayers get the same proportionate cut.

I would also like to see expenditures increased as an antirecession measure. Unfortunately, the kind of expenditures that are being voted these days do not seem to me to be of the highest priority. Their timing, moreover, will probably produce a maximum impact 1 or 2 years from now. Therefore, I limit myself to suggesting greater expenditures for research and education.

Sincerely yours,

HENRY C. WALLICH.

UNIVERSITY OF PENNSYLVANIA,
WHARTON SCHOOL OF FINANCE AND COMMERCE,
Philadelphia, Pa., March 10, 1958.

Hon. HARRY F. BYRD,
Chairman, United States Senate Committee on Finance, Washington, D. C.

DEAR SENATOR BYRD: Enclosed is my reply to the questionnaire forwarded in your letter of February 17. Please note that the two articles attached are an integral part of my reply.

Sincerely yours,

C. R. WHITTLESEY,
Professor of Finance and Economics.

ANSWERS TO QUESTIONNAIRE ON "INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES"

(Several of these questions are adequately discussed in a number of textbooks on money and banking. I have treated some of them in my own text more fully than I possibly can do here. Certain of them are covered in articles I have written, copies of two of which are attached.)

1. Give a definition in your own words of deflation and inflation.

There is no "correct" definition of these terms. Differences reflect the choice of different individuals as to features which they particularly wish to emphasize. The words conform best with general usage, however, when they are thought of as follows:

Inflation, a persistent tendency toward rising price levels. "Creeping inflation" customarily refers to a continuing price-level rise amounting to around 2 percent a year, but unless qualified a considerably greater rate of increase than this is ordinarily implied by the term "inflation."

Deflation, a situation of growing unemployment and idle capacity with some tendency toward weakness in prices.

2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

Changes which have taken place in the past quarter of a century have greatly moderated tendencies in the direction of deflation while somewhat increasing tendencies toward inflation. Reasonably intelligent monetary and fiscal policies (such as many competent economists inside and outside the Government are qualified to describe in detail) are sufficient to prevent serious inflation or deflation. The chief requirement for such policies is a reasonably high degree of freedom and independence for the monetary and fiscal authorities. The principal threat to such freedom is political interference originating with a wide variety of pressure groups.

If greater independence to pursue stabilization policies can be safeguarded by law this should be done. In addition, the Federal Reserve should be given further powers, including standby authority to regulate consumer and mortgage credit and possibly to impose special reserve requirements. (Present difficulties in the automobile industry as well as current problems of overcapacity could have been greatly ameliorated by the use of selective credit controls in 1955, as I suggested before a congressional committee at the time.) Laws should be enacted to enable the activities of the governmental lending agencies to be effectively coordinated with those of the monetary and fiscal authorities.

3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942 to 1957. (You may wish to divide the period into two parts, 1942–50 prior to the accord, and 1951–57.)

I have discussed all but the latest phase of this subject in an article entitled "Central Bank Policy in the Light of Recent American Experience," published in the Weltwirtschaftliches Archiv. A copy of this article is attached. As is pointed out therein, pages 22–24 and elsewhere, gross misconceptions prevail with respect to events, attitudes, and policies before and after the accord of 1951. Consciously or unconsciously, many of these misconceptions have been propagated by officials in high places.

Changes which have taken place in recent decades have rendered the Government bond market inherently unstable. Monetary (and to a less extent fiscal) policy has failed to make sufficient allowance for this fact. The latest gyrations in the bond market occurred in 1957–58 but are sufficiently explained in the article mentioned above, especially pages 29–30, 40–41, and in another article entitled "Monetary Policy and Economic Change" published in the Review of Economics and Statistics, copy of which is also attached. (Please note especially pp. 33–35.)

4. Beginning in August 1956 there was an increase in the Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

A minor correction: The rise in prices was not a cause of the fall in the value of money. Each is an expression of the other; they change together and necessarily in a reciprocal, i. e., inverse, relationship.

An important factor in the price rise was the somewhat fortuitous but sharp increase in the food component of the index in 1956. The impact of this factor was relayed through escalator clauses in wage contracts. A rather more basic element was the overexpansion of plant and equipment expenditures. This was influenced by overoptimistic expectations arising out of earlier excesses in consumer credit extension and in the demand for automobiles. The expression "wage-price spiral" describes a process; it does not explain causes. Fluctuations are inescapable in our free-enterprise, free-choice economy, but this particular disturbance could have been moderated by a judicious use of selective controls (as President Allan Sproul of the Federal Reserve Bank of New York and various academic economists argued at the time).

5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

The enlargement of the public debt came about so suddenly that our thinking and our policies failed to keep pace with it. We have tried and still are trying to maintain a small-debt philosophy in a large-debt world. Both Treasury and Federal Reserve officials have been at fault in their approach to the problem of the national debt.

The large national debt is not an unmixed evil. It has helped to impart stability to our money supply and safety to our banks and other financial institutions, but it has done so at the cost of an inherent tendency toward instability of the Government bond market. Fluctuations in security prices and interest rates have been so large as to contribute to self-inflammatory movements in the security markets, interfere with Treasury financing, create manifold injustices in the form of windfall gains and losses, and probably distort production and trade. I believe that we shall learn from experience and that by 1970 or perhaps sooner shall be managing the public debt quite differently from the way it has been managed up to now. The basic difficulty is that we have carried forward from a small-debt past ideas which are unsuited to the large-debt world in which we live and are destined to continue to live. The Canadians seem to have done a better job with debt management than we have; I suspect that we could learn a great deal from them.

6. (*a*) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand, and employment.
3. Economic growth in production, demand, and employment.

All three of these objectives are highly desirable. No rigid order of priority among them should be attempted; our goal must be to achieve all three. They are not incompatible or over the years necessarily in conflict. The important point to bear in mind is the need to effect a balance among them, recognizing that in order to achieve a satisfactory measure of one, for example, price stability, we may sometimes have to forego for the time being a conceivably attainable degree of another, for example, economic growth.

The danger lies in setting too narrow a target. If, for example, we were to establish a goal of no more than 2 million unemployed at any one time we should quite certainly be confronted with the imminent danger of inflation. On the other hand, if we were to set our goal in terms of a range of, say, from 2 to 5 million unemployed there need be no conflict among the three objectives. To arrive at the precise terms of an economic program would require careful study but one thing is certain, at the extremes, i. e., where either inflation or deflation threatens to cross the predetermined limits, the authorities should be prepared to move with the utmost vigor and dispatch. The certainty that strong measures would be forthcoming at the extremes would automatically tend to induce such responses on the part of the consuming and investing public that the probability of intervention by the authorities, far from being increased, would in fact be minimized.

6. (*b*) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

The price rise that occurred in 1955–57 was excessive and could and should have been avoided. Employment was perhaps at a level in excess of what is readily compatible with price stability. Certainly the rate of growth in business investment appears to have been abnormally high. In short, we did not effect a happy balance among the objectives of price stability, full employment, and economic growth. To the extent that we overdid the second and third objectives, high-level employment and growth, we interfered with attainment of the first, stability of prices. And if the result should be to have produced a depression the long-run effect may well have been to obstruct all three.

7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

Sustaining.

8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

The tax system of none of the governmental units approaches the ideal but we are pretty well adjusted to them. The familiar contention either that they impair incentives or seriously distort economic activity is not well substantiated. Waste and extravagance are undoubtedly encouraged to some extent. Tax reform is a perennial problem, but at any given time its importance is less than crucial.

9. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy, and then relate them, one to the other. Please discuss these policies, stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

This topic seems too elementary and detailed to enter upon here. I cover these matters in several chapters of my Principles and Practices of Money and Banking, Macmillan, revised edition, 1954. They are adequately discussed in many other texts and treatises.

10. (*a*) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purpose of this question consider that the monetary system includes bank deposits and bank credits.) Also, please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

An ideally better monetary system could be devised but the one we have is the best by far that this country has ever known and it is good enough for the job it has to do. From the standpoint of overall economic policy, the most important improvement would be to increase the independence (from the President and Congress rather than from the Treasury) of the Federal Reserve and increase its flexibility and the number and variety of powers at its disposal.

10. (*b*) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

Fiscal policies for promoting economic stability are unavoidably deficient in promptness and flexibility. Whatever is possible should be done to overcome these defects. On the whole, however, remedial efforts should be directed principally toward strengthening the so-called automatic stabilizers. We should, of course, continue to close

tax loopholes, improve administration, and try to overcome inequities.

11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

A considerable number of unemployed are to be expected under full employment or even under inflationary, i. e., overemployment, conditions. In addition, bottlenecks, as the German experience demonstrated after the First World War, can cause heavy unemployment even with rampant inflation. The idea, however, that an unprecedented combination of excess unemployment and inflation existed in the United States in February and March 1958 is erroneous. There was no significant inflation at that time and much of the rise in unemployment was of a seasonable character. Our error lay in assuming that the low figures of unemployment to which we had become accustomed in the preceding 3 or 4 years, rather than a somewhat higher figure, were to be identified with conditions of full employment. My answer to this question, therefore, is twofold. First, to the extent that unemployment coincided with inflation, it was to be attributed to frictional elements or bottlenecks. Secondly, the popular notion that a new economic era, characterized by chronic inflation combined with abnormal unemployment, has arrived is a delusion which time will shortly disprove.

11. (*b*) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

No, such a course is neither desirable nor necessary. See answer to question 6.

12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy?

The level of debt in terms of both totals and components does not alarm me for reasons discussed in chapter 9 of the money and banking text referred to above. The most important feature of debt is the rate of change in its amount, since it is this that is closely related to current spending on consumption and investment. A glance at the Federal Reserve Chart Book, Historical Supplement, will show how rapidly various forms of debt have risen in the United States since 1945 (see pp. 54, 68, 71, 114). The impetus thus given to aggregate demand for the products of American industry was beyond what could reasonably be expected to continue.

I find extremely disturbing the thoughts that:

1. Our prosperity may have rested to a significant degree upon this rate of debt expansion.
2. The rate of increase may not continue.
3. It may continue.

My answer, then, is that I believe that the rate of growth of private debt has at times since 1945 been excessive to the degree of jeopardizing the stability and continuing vitality of our economy. Moreover, I believe that this threat could have been appreciably lessened if the views of Allan Sproul and certain others (myself included) had been allowed to prevail.

13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways,

such as a tax cut and/or large increases in public works, to counteract a downturn in the economy?

The general outlines of my answer to this question have been indicated in my answer to question 6. If we sincerely believe what we continuously maintain, namely, that this country has a strong and dynamic economy, we should give it an opportunity to demonstrate its strength and resiliency. We cannot do so by coming forward with governmental crutches at the first sign of a downturn in business. I recognize the natural fear that a decline may become harder to arrest because it is allowed to proceed too far. Nevertheless, I should refrain from such measures as are suggested here until unemployment and the decline in industrial production have gone considerably further than at present. Figures for unemployment reached nearly 5 million in 1950 with a smaller labor force than at present. For seasonal reasons the totals characteristically rise in the early months of the year. I believe that precipitate action should be avoided and extreme measures deferred until unemployment has risen above the 5 million mark at midyear or somewhat above that figure at the usual seasonal peak of February, but I should leave no doubt whatever that the action of the Federal Government would be all out once it had undertaken to stem the downturn. (This does not, of course, preclude such earlier easing of credit as the Federal Reserve has already undertaken.)

14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

Deficit financing since the end of World Was II was not a significant factor in causing inflation. The inflation in this period was mainly the delayed result of developments that occurred during World War II and of factors resulting from the Korean war. Even the upward movement of rents and services which figured in the rise in the Consumer Price Index was of this delayed character. The latest phase of the inflationary movement, 1955–57, was partly the result of miscalculations by businessmen which contributed to overexpansion in certain lines and overinvestment quite generally.

15. Can full employment goals be attained while maintaining a dollar that has relatively stable purchasing power?

Yes. A critical point in answering this question, however, is the determination of levels at which the employment goal is set. See answer to question 6.

16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

They are not incompatible, although they are a complicating factor. Their tendency is to prolong a self-inflammatory movement of prices and wages once it gets started. This is one of the reasons why we must not be premature in adopting expansionist measures when a lull in an inflationary movement begins. Likewise it is a reason for increasing the powers, flexibility, and independence of the agencies charged with maintaining economic stability. Obviously, also, it gives price stability key importance in the list of objectives discussed earlier.

In short, to the extent that we prevent an inflationary rise in the price level from getting started, escalator provisions are not a menace to economic stability. To the extent that we fail to accomplish this objective, they do constitute a threat to stability.

17. List and briefly discuss what you consider the cause of the present recession, and what should be done to terminate it.

Among the causes of the present recession I would list the following:

Overexpansion of business investment in 1955–57.

Overstimulation of consumer durables, especially automobiles, and of housing somewhat earlier.

Undue reliance on general instruments of credit control.

Misconceptions as to the nature and history of inflation in this country.

Shortsighted price and wage policies for which both employers and union leaders are responsible.

My recommendations as to policy are indicated in earlier answers, especially under questions 6, 13, and 16.

Central Bank Policy in the Light of Recent American Experience

By Prof. Charles R. Whittlesey, Philadelphia, Pa.

For the United States the period after World War II was noteworthy for dynamic, almost explosive, developments in the field of central banking. Pronounced shifts in policy occurred. Subordination of Federal Reserve policy to Treasury operations during and immediately after the war gave way to a high degree of freedom and independence. Extreme reliance on fiscal policy for influencing economic activity, which, like the subordination of the central bank to the Treasury, was largely a legacy from the great depression and the period of war financing, gave way to increased confidence, perhaps overconfidence, in monetary policy in the form of traditional central bank controls over credit. Inflationary stresses proceeding from the Korean crisis subjected both monetary and fiscal policy to a severe test which was only moderately well sustained. This was followed by periods of pronounced instability in the market for United States Government securities.

The most important development of all from a scholarly viewpoint was the publication of a series of significant documents relating to all phases of central bank policy including relations with the Treasury. These were the product of two separate investigations, carried out by subcommittees of the United States Congress headed respectively by Senator Paul Douglas, of Illinois, long a professor at the University of Chicago and a former president of the American Economic Association, and Representative Wright Patman, of Texas, who was well known for his interest in monetary and banking affairs. The materials embraced in these documents included, besides reports of the subcommittees themselves, lengthy and revealing statements from the Secretary of the Treasury, the Board of Governors of the Federal Reserve System, and presidents of the Federal Reserve Banks. In addition, there were oral testimony and written answers to questionnaires from professional economists, bankers, insurance officials, and others. The documents were supplemented and brought up to date by subsequent hearings and committee reports.

A final development worth noting was a considerable number of proposals, chiefly contained in the documents already mentioned, for modifying the Federal Reserve System itself. Some of these took the

form of specific recommendations or tentative suggestions from the Board of Governors and other officials of the Federal Reserve System. Others came from outside the system. They ranged all the way from proposals for minor changes in operating technique to the recommendation by a highly regarded economist at one of the country's leading universities that the Federal Reserve System be abolished.

I. CENTRAL BANK POLICY FORM WORLD WAR II TO THE TREASURY-FEDERAL RESERVE ACCORD OF 1951

The history of the Federal Reserve System in the first years after the end of World War II is chiefly a record of attempts of the Federal Reserve authorities to throw off existing limitations on their power to control credit. These limitations were themselves largely a consequence of policies introduced during the war. On the day after the entry of the United States into the war the Board of Governors announced that its major objectives would be: "* * * to assure that an ample supply of funds is available at all times for financing the war effort and to exert its influence toward maintaining conditions in the United States Government security market that are satisfactory from the standpoint of the Government's requirements".[1] Within a short time two distinctive measures had been put into effect to carry out these objectives. They provided for the purchase and sale of Treasury bills at a guaranteed rate and for establishment of a fixed pattern of interest rates on all Government obligations.

The statement of Federal Reserve objectives was regarded as clearly necessary at the time and was accepted without opposition. Likewise, the two principal methods for carrying out this policy were accepted as reasonable and appropriate. It was only gradually realized that the combination of policies was incompatible with effective use of the general instruments of credit control by the Federal Reserve authorities. The basis of this incompatibility is not difficult to explain. The agreement by the Federal Reserve to buy Treasury bills at a guaranteed rate made it possible for any member bank holding bills to demand reserves whenever it so desired. The commitment to maintain a fixed pattern of interest rates on all Government securities extended this power of member banks to control the creation of reserves to all banks holding whatever types of Treasury obligations were in existence.

In order to prevent yields from rising above the established pattern of rates, the Reserve authorities were compelled to purchase any issue whenever it was offered at a yield corresponding to the established pattern of rates. These purchases by the central bank supplied member banks with reserves whether or not the banks were sellers of the securities purchased. Thus the inevitable consequence of providing a guaranteed market for Treasury bills and of establishing a fixed pattern of rates on other Treasury securities was to make it impossible for the Federal Reserve authorities to refuse to furnish reserves. The initiative in determining the volume of reserve had by these means passed from the central bank to the member banks or other holders of Treasury obligations.

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[1] Federal Reserve Bulletin, vol. XXVIII, Washington, 1942, p. 2.

In short, because of the policy of supporting the Government bond market, that is, maintaining a pattern of interest rates, it was no longer possible for the Federal Reserve to control the volume of member banks reserves. Because the Federal Reserve could no longer control reserves, it could no longer control credit by means of the general instruments of credit control. This was the situation in which the Federal Reserve found itself in the period of strong inflationary pressures following the conclusion of hostilities.

The effect of the support policy in impairing the general instruments of credit control was first pointed out by certain academic economists. Even if this effect had been recognized in advance, however, it would probably have made no difference in the adoption of the support policy; orthodox monetary methods had fallen out of favor and experience in the First World War when interest rates were allowed to rise was interpreted as justifying measures to limit increases in interest rates.

By 1950, partly because of the inflationary pressures released by the Korean war, the Federal Reserve found itself at odds with the Treasury over abandonment of the policy of supporting Government securities at par, a step strongly resisted by the Treasury. The conflict was colored to some extent by political and personal considerations. Both at the time and afterward the issue was often depicted in terms of an attempt, by a more or less authoritarian and socialistic administration desiring to continue to finance an unduly expanded public debt at an artificially low rate of interest, to overrule an enlightened and dedicated body of central bankers who were fighting to defend the public against inflation and the free-enterprise system against subversion. As will be shown presently, any such interpretation is anything but precise.

In the end, and after intervention by the President, which for the moment had the effect of increasing rather than diminishing the violence of the controversy, an agreement was reached in March 1951 which has since been known as the Treasury-Federal Reserve accord. The rigidity of the support policy was relaxed and certain changes in Federal Reserve personnel were effected. The harmonious relations which existed between Federal Reserve and Treasury after the accord may, perhaps, be explained not only by the terms of the agreement but also by the fact that both sides had become thoroughly sick of the squabble and could recognize the damage which resulted from the spectacle of the monetary and fiscal authorities appearing publicly to be at such great odds.

The accord is generally regarded as constituting a turning point in the history of Federal Reserve operations. For this reason, and because of certain misconceptions concerning the events of the period, a brief review of the major issues is in order. In the first place, the independence of the Federal Reserve from Treasury domination became a rallying cry for more extreme supporters of the Federal Reserve and for numerous critics of the Democratic Party which was then in power. It was expressed most vehemently by the very persons who a little earlier had been least willing to grant the Federal Reserve additional powers to carry out duties with which it had been charged or to allow it to control consumer credit.

It is to be noted that the Federal Reserve is legally a creature of Congress and accountable to Congress. In this sense it is admin-

istratively distinct from and independent of the executive arm of the Government to which the Treasury belongs. Moreover, the Federal Reserve Act, under which the System operates, is a safeguard against undue interference in the activities of the Federal Reserve even by Congress itself. On these points there is no real dispute.

On somewhat broader grounds, however, the simple truth must be recognized that there can be no such thing as the literal independence of the Federal Reserve from the Treasury, or, for that matter, of the Treasury from the Federal Reserve. Each is a prisoner of the other. The actions of either are bound inevitably to enter into the discharge of the other's responsibilities. The problem, therefore, is not one of independence but one of coordination. The evidence of the postwar years suggests that the operational independence of the Federal Reserve is threatened less by the Treasury than by Congress which at one time interfered with Federal Reserve operations by changing the terms of regulation W for the period of consumer credit and at another time summarily removed the power of the Board to apply such controls.[2]

A second major issue involved in the Treasury-Federal Reserve accord had to do with the priority of objectives and means. In time of war, as is generally recognized, the wishes of the Treasury tend to dominate the actions of central banks. Such a subordination of the central banks is apparently not something forced upon them against their will, but conforms to what they also regard as a necessity under wartime conditions. Even in peacetime, officials of the Federal Reserve repeatedly accepted the view that the existence of a large public debt is a factor requiring modification of monetary policies employed under a different set of conditions. Thus in their Annual Report issued in the middle of 1949 the Board of Governors declared: "In earlier periods * * * Federal Reserve policies could be * * * directed * * * toward * * * reserves * * *. With a large Government debt which is likely to be a dominant part of the debt structure for many years, the Federal Reserve has to cope with the dual problem of maintaining an orderly Government security market and exercising control over the volume of bank reserves".[3] In the same year, the Chairman of the Board of Governors was even more explicit in defending the support policy: "The market for Government debt securities must be one where investors can deal at all times with confidence * * *. For the foreseeable future the support program must be continued. This conviction is shared by all members of the Board of Governors, the Open Market Committee, and the Treasury".[4] In these and similar statements, officials of the Federal Reserve repeatedly stressed the importance of stabilizing the market for Government securities. The Treasury, in turn, was no less specific in demanding that policies be pursued with a view to minimizing the danger of inflation.

It is a gross misrepresentation to suggest, as has often been done, that the Treasury was unmindful of the hazards of inflation and the Federal Reserve unmindful of fluctuations in the Government bond

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[2] Somewhat similar infringements of the Reserve Board's freedom of action occurred in connection with the control of real-estate credit (regulation X) and the voluntary credit-restraint program both of which were introduced at the time of the Korean war.

[3] Board of Governors of the Federal Reserve System, Thirty-fifth Annual Report Covering Operations for the Year 1948, Washington, p. 4.

[4] Thomas B. McCabe in a speech at Philadelphia.

market. The major difference in the attitudes of the two sides was not over objectives but over the policies required to achieve those objectives. Earlier statements from Federal Reserve sources indicated a belief that powers they already possessed were adequate or that additional powers would be forthcoming which would make it possible at one and the same time to maintain control of reserves and orderliness in the security markets. The subsequent split between Treasury and Federal Reserve officials may be assumed to reflect in some degree a disillusionment on this score by Federal Reserve officials which the Treasury had not yet come to share. The question may be raised whether under the circumstances criticism should more properly have been directed toward the Treasury for having continued to stress the second objective, which the Federal Reserve only a short time before had likewise stressed, or toward the Congress which failed to provide the supplementary powers which were requested by the Federal Reserve as a means of attaining the dual objective.

It is also apparent that there was a considerable difference of opinion as to what constituted the most appropriate instruments for achieving economic goals. The Treasury continued to place considerable faith in fiscal methods of combating inflation as well as in the selective instruments of credit control. The Federal Reserve, on the other hand, came to the point of advocating almost complete reliance on the general instruments of credit control, particularly open-market operations and discount policy which were precisely the instruments which had been largely stultified by the support program. The Treasury's position, it may be noted, was dependent upon Congress taking appropriate action to resist inflationary pressure by imposing adequate taxation and authorizing the use of selective controls. This sort of cooperation Congress was not willing to provide.

The precise merits of the two sides in the dispute over the support policy are not always easy to determine. It is impossible even at this distance to say which was more nearly in the right. But it may safely be stated that the accord enabled the Federal Reserve to escape to some extent from a position of subordination inherited from the period of the Second World War and that it thereafter became possible for Federal Reserve officials to carry greater weight in the formulation of financial policies jointly with the Treasury.

Developments after the accord will be described presently. Here an attempt will be made to dispel certain misconceptions as to the nature of conditions that prevailed before the accord. The view is frequently encountered that serious inflationary conditions prevailed before the accord and that a degree of stability close to perfection exist after that time. The conclusion is likely to be drawn, even when not explicity supplied, that it was the accord that made the difference. Such extreme statements appear even in statements submitted to Congress by the Federal Reserve: "The facts are that debt was monetized in volume and that the country suffered a serious inflation until the Federal Open Market Committee abandoned the pegs. * * * During the period of pegging prior to the Treasury-Federal Reserve accord of March 1951 * * * the Federal open-market account * * * performed the function of making continuous markets for most maturity sectors even including the very short end

of the market. It did so, of course, at the expense of monetary policies appropriate to the stability of the economy. The reserve funds that were made available almost automatically under the technique of pegging operated to augment the availability of credit and thus to increase the demand for commodities to a volume that was in excess of what could be supplied. The result was to incorporate into the base of the price structure a spiral of rising costs and prices. This inflationary process was stopped early in 1951 when the Federal Open Market Committee discontinued pegging the prices of United States Government securities." [5]

This statement of events has been challenged by Professor Hansen in words that merit extended quotation for their explicitness and force: "There occurred no 'mounting' monetization of the debt. On the contrary, Federal Reserve holdings were $5.1 billion *less* in June 1950 than in December 1946. The debt was not 'monetized in volume.' The banking system held $14 billion less bonds in June 1950 than in December 1946, while the nonbank public held $13.5 billion more. The money supply did not increase. Currency plus demand deposits stood at $110.2 billion in June 1950 and $110 billion in December 1946. We did not have continuous inflation in the preaccord period. Wholesale prices in June 1950 stood at the same level as in September 1947, a period of nearly 3 years. Loans and investments of commercial banks remained stationary from 1946 to 1948, but rose moderately before Korea. Member bank reserve balances stood at $16.1 billion in December 1946 and at $16.3 billion in June 1950. Money and bank credit were not running wild * * *. It would be difficult to find statements more misleading than those cited above. The reader is not told that the peg on the short-term was removed 4 years before the accord. He is not told that the support of the long-term was a floor support, not a fixed peg. He is not told that during most of the period the long-terms were selling above the support price. He is not told that the money supply in fact did not increase up to Korea. He is not told that wholesale prices were falling for about 2 years before Korea. The reader is led to believe that there was a continued spiral of rising costs and prices all through this period. Nor is the reader informed that the price spurt following Korea was stopped a month before the accord—the weekly index reaching the peak figure on February 13, 1951." [6]

The facts, as Dr. Hansen has shown, are clear enough for the period from the end of the war in 1945 to the accord in early 1951. What is not clear and in the nature of things cannot be wholly clear is what these facts prove with respect to the monetary policies followed during the period.[7] The basic cause of inflation after the war was the extreme liquidity then present in the economy. This liquidity was a product of methods of war finance over which the central bank had no control.[8] Rationing and other influences prevented the expansion of

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[5] United States Monetary Policy: Recent Thinking and Experience, hearings before the Subcommittee on Economic Stabilization of the Joint Committee on the Economic Report, December 6 and 7, 1954, Washington, 1954, pp. 278, 20. (Hereafter referred to as hearings of 1954).

[6] Alvin H. Hansen, "Monetary Policy," The Review of Economics and Statistics, vol. XXXVII, Cambridge, Mass., 1955, pp. 116 sq.

[7] It is to be observed that Dr. Hansen's marshaling of facts is designed to contest the certainty of claims advanced by others, not to support counterclaims of his own.

[8] Criticism of inflationary methods of financing the war, particularly the limited reliance on taxation, was voiced during the war by numerous academic economists, but, understandably of course, not by Federal Reserve authorities.

the supply of currency, demand deposits, and other liquid assets from forcing prices up during the war years. The very success of price-stabilization efforts at that time aggravated the inflationary potential at the end of the war. The strong demand for consumer goods and capital investment, together with the early removal of direct controls over spending, was enough to cause inflation in spite of anything the Federal Reserve could possibly have done.

General instruments of credit control, such as would presumably have been available in the absence of a support policy, might have made it possible to check monetary expansion. But this, as Professor Hansen points out in the article quoted, was not the problem; the basis of the difficulty, rather, was the purchasing power already in existence. Whether more vigorous application of the selective instruments of control, designed as they are to control the use of money already in existence rather than the creation of additional money, would have helped is quite a different question. But it may be that, as Reserve officials have intimated, pressure from the public and more directly from Congress would, in any case, have made impossible the use of selective instruments of credit control.

The purpose of this brief review has not been to provide a blueprint of Federal Reserve policy as it might ideally have been during the early postwar period but to show what actually occurred in order to indicate the complexities that existed at the time as well as some of the confusions and misconceptions that have arisen since. All this is essential to an understanding of developments in the period following the accord.

II. MONETARY POLICY AFTER THE ACCORD

1. Summary of economic developments

The accord had been preceded by an inflationary upsurge arising out of the war in Korea. Business activity continued strong for some time after the accord but without the previous strong upward pressure on prices. The index of industrial production had hovered around 100 in the years after the end of World War II, rising to an average of 104 in 1948 and falling to an average of 97 in 1949. With recovery from the recession of 1948–49 and under stimulus of the Korean war, the index rose to 112 for the year 1950.

The seasonally adjusted figure for February 1951, the month immediately before the accord, was 122 and the unadjusted average for the year was 120. The index dipped sharply in the middle of 1952, primarily because of a strike of steelworkers, but rose thereafter with the average for the year standing at 124. The strength continued into 1953, carrying the adjusted index to 137 at midyear. A sharp reaction then set in, but even so, the average for the year was 134. For the first 9 months of 1954, the adjusted index ranged between 123 and 125, and the average for the year, despite some improvement at the end of the year, was 125. Recovery from the recession of 1953–54 was rapid, however, and by the summer of 1955 the seasonally adjusted figure at 140 was above the previous peak.

A roughly similar story is told by unemployment figures. Unemployment remained low after the accord, reaching a low point of 1,162,000 (partly because of seasonal influences) some months later

than the peak of industrial production was reached. A rapid rise in unemployed then followed which carried unemployment totals to 3,725,000 early in 1954. Subsequent improvement, while substantial, left the total of unemployed a million or so above the figure that had prevailed before the recession.

It was in the field of money rates, however, that the most spectacular changes occurred after the accord. For years the prices of Treasury obligations had been subject to support at par by the Federal Reserve and during much of the time they had prevailed at levels considerably above par. With the abandonment of the commitment by the Federal Reserve to support Governments at par and the subsequent issuance of securities bearing interest at 2¾ percent, the older 2½ percent bonds fell below par as did other issues. The yield on long-term issues fluctuated more widely and more frequently than they had done before the accord and, as was to be expected, shorter-term issues also moved with comparative freedom. The price of long-term Governments, which had stood at an average of 102.73 in 1949 and 102.53 in 1950, averaged 98.85 in 1951 and 97.27 in 1952. The figure for 1952 reflected a monthly low of 96.27 in January and a monthly high of 98.91 in May. The figure for November, the month in which the Republicans under General Eisenhower defeated the Democrats at the polls, was 96.96. A decline set in which was gradual at first and then increasingly rapid:

December 1952	96.32	March 1953	94.31
January 1953	95.68	April 1953	93.25
February 1953	95.28	May 1953	91.59

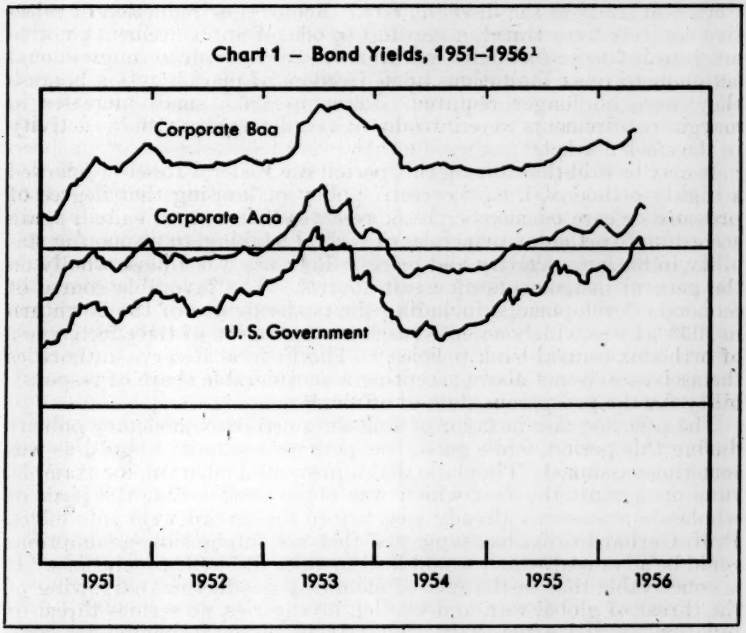
A low point of 90.74 was reached for the week ending June 6, with individual issues falling a little below 90.

Following what was generally interpreted as a change in the attitude of the Federal Reserve toward steadying the Government bond market, a recovery set in and soon prices were rising as rapidly as they had fallen. For December the average stood at 95.85, close to where it had been in January. A month later it was at 97.42 and by April 1954 it was above par at 100.36. Prices close to par were maintained throughout 1954 but in 1955 weakness again devleoped which carried quotations down from an average of 98.97 in December 1954 to 94.04 in the last week of July 1955. After recovering from these levels weakness again developed in 1956.

Fluctuations of this character in the Government bond market, occurring at a time of peace, prosperity, and business optimism, were without precedent in the history of the United States. The fact that fluctuations in yields on short-term and intermediate Treasury issues were greater than on the long-term issues conforms to normal expectations. What comes as a distinct surprise is that Government bonds were less stable during these years than corporate bonds of either the highest or the next to the highest quality ratings (see chart I).

2. Summary of Federal Reserve policies

In an official statement the Federal Reserve reported that it endeavored after the accord: "* * * to adjust its policies so as to influence the level of bank reserves and the money supply in accordance with seasonal requirements, the capacity of the economy to produce goods and services, and sustainable economic growth in the economy. The discount function was restored as a means of supply-



[1] *Source:* Board of Governors, *Federal Reserve Charts*, Washington, May 1956, p. 25.

ing temporary needs for Federal Reserve credit in a manner that exerted restraint on unwarranted uses of such credit, thereby complementing open-market operations in influencing the availability of credit at member banks. Discontinuation of rigid pegging of Government security prices removed the possibility of monetizing the public debt through sale to the Federal Reserve System at the initiative of the holders, nonbank as well as bank, and without loss to them. The excess liquidity of the economy was thereby removed."[9] In resisting inflationary tendencies and later in its so-called policy of "active ease" directed toward combating the recession of 1953–54, chief reliance was placed on open-market operations.[10] Changes

[9] Hearings of 1954, p. 6.

[10] Federal Reserve authorities designated open-market operations as expansive or restrictive in terms not of their simple tendency when viewed by themselves but of their combined effect when taken in conjunction with other forces operating in the market. Thus net purchases of Government securities amounting to $1.8 billion in the second half of 1952 were classified as restrictive. They were restrictive in the sense that open-market purchases were limited to $1.8 billion rather than being of a larger amount; with purchases at this scale banks were still under pressure to borrow in order to obtain needed reserves. This is analogous to saying that purchases of $1 million of wheat have a depressive influence on price if it would take $1.2 million to offset changes elsewhere and prevent the price of wheat from falling.

It would be much more accurate to say that restrictive forces were operating to create a deficiency of reserves of, say, $2 billion and these were offset by purchases, necessarily expansive in themselves alone, of only $1.8 billion so that the combined effect was restrictive. Admittedly the net outcome is the same whichever way it is stated, but, aside from one's logical qualms over the way the Federal Reserve expresses it, the effect is to obscure, or even apparently to deny, the existence of nonpolicy influences operating in the economy. In the illustration given should not the restrictive effect be attributed to the external factors operating to create a shortage of reserves and not to actions by the Reserve authorities which offset them only in part? On the Federal Reserve's own assumption, to

were also made in the discount rate. Removal or reduction of selective controls were timed, according to official announcements, not so much to influence economic conditions as to conform to congressional action or to relax limitations upon freedom of market action because they were no longer required. Later in 1955, small increases in margin requirements were introduced as a deterrent to undue activity in the stock market.

It may be said that during this period the Federal Reserve followed a highly orthodox, i. e., "correct," policy of keeping that degree of pressure or ease on member bank reserves that seemed suited, again according to orthodox principles of central banking, to promoting stability in business activity and prices. Reliance was almost wholly on the general instruments of credit control. The favorable course of economic developments, including the moderateness of the downturn in 1953–54 was widely accepted as a demonstration of the effectiveness of orthodox central bank policies.[11] The Federal Reserve authorities themselves were not above accepting a considerable share of responsibility for the prosperous state of affairs.[12]

The post hoc case in favor of following orthodox monetary policies during this period, while good, was perhaps not quite as good as was sometimes assumed. The claim that it prevented inflation, for example, runs up against the fact which was noted earlier that the peak of wholesale prices was already past before the accord went into effect. Prof. Gerhard Colm has suggested that not implausible assumptions could be advanced which would lead to quite different conclusions. It is conceivable that in the fact of mounting production, narrowing of the threat of global war, and swollen inventories, no serious threat of inflation existed after early 1951. It has been intimated by some that restrictive policies of the Federal Reserve may have been excessive. Prof. Milton Friedman has, in fact, gone so far as to argue flatly that the recession of 1953–54 was the direct consequence of restrictive measures adopted by the Federal Reserve.

Such words of criticism were distinctly the exception. In general, actions taken by the Federal Reserve during these years were regarded as having been intelligently formulated and of a character to contribute to the attainment of accepted goals of central bank policy. The precise degree of that contribution remains uncertain, as does the extent to which similar methods could be expected to cope with future disturbances.

Much greater controversy has centered about the violent fluctuations in prices of Government bonds, particularly in 1953. The Board of Governors tended to dismiss the incident as a simple market phenomenon of only secondary importance: "Interest rates rose during the

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have made no purchases at all would have been even more restrictive. It is extremely awkward to suggest that the purchases as such were restrictive.

To be exact, the Federal Reserve action was not of a character to restrict but rather to soften and ameliorate independent restrictive influences which were operating at the time. On this basis, the role of the Federal Reserve appears to be not that of a stabilizer which offset tendencies toward inflation and deflation, but that of a stabilizer which resisted the tendencies of independent forces to offset them too sharply. This may be of no less importance to the economy and is clearly no less to the merit of the Federal Reserve authorities. The distinction, however, is of great significance from the standpoint of intelligent interpretation.

[11] See, for example, Report of the President, Joint Committee on the Economic Report, Washington, 1955, p. 22.

[12] In discussing restraints applied in 1952–53 they stated that "inflation was prevented" (hearings of 1954, p. 8). The subsequent policy of credit ease was interpreted as making a major contribution to recovery from the 1953–54 decline.

period, reflecting the pressures of credit demand in excess of the available supply."[13] At other times the rise was interpreted as part of a tightening operation called for by the continuation of a severe inflationary threat.[14] On the other hand, various critics, particularly experts testifying before congressional committees, interpreted the sharp drop in bond prices as an unfortunate speculative incident resulting in considerable measure from bungling by public officials.

It may be recalled that the Democrats had been strongly criticized for maintaining interest rates at artificially low levels. Some of the most vocal of these critics succeeded to high positions in the incoming Republican administration. The financial community was inclined to assume, first, that the existing level of rates actually was unduly low and, second, that the new administration would allow or even encourage them to rise. It was expected that a vigorous effort would be made to lengthen average maturities of outstanding Treasury obligations by pushing the sale of long-term issues. Ensuing declines in the Government bond market tended to feed upon themselves. Reports circulated in financial quarters that lower prices were in prospect. Selling was induced, which contributed to lower prices, thereby substantiating the past rumors and generating fresh rumors of further declines. At this juncture the Treasury brought out a new long-term at 3¼ percent interest, a rate considerably higher than had been offered for many years.

The view that this was but the forerunner of still higher rates was strengthened by statements from the Under Secretary of the Treasury, a prominent ex-banker, that it would be the policy of the Treasury to offer whatever rate was necessary in order to meet the market. At about the same time the Chairman of the Board of Governors was quoted as stating in a public address that the Federal Reserve would intervene in the Government bond market only under extreme circumstances. The first official declaration was interpreted as an invitation to speculate on declining prices for Governments and the second as announcement of a policy of "let 'er rip."

By May and June, alarm over the weakness in security markets had become widespread. Without formal announcement of a reversal of policy, actions by the Federal Reserve in supplying reserves though open-market purchases and later in reducing reserve requirements were interpreted as constituting such a reversal. Thereupon expectation of a decline in Governments quickly gave way to equally firm expectations of a rise. With increased availability of reserves and a slacking in the demand for credit, banks and others who had been dumping Governments now turned to buying them. The rising trend tended to feed upon itself much as had happened during the preceding downward movement. No attempt was made by the authorities to interfere directly in stabilizing the market or Government bonds. Open market operations were confined exclusively to dealings in Treasury bills.

3. The problem of judging the effectiveness of monetary policy

Disagreement as to the exact role which monetary policies played in the events of the postwar decade, no less than the diversity of opinion

[13] Hearings of 1954, p. 8.

[14] Such an interpretation is inconsistent with the statement in the Fortieth Annual Report Covering Operations for the Year 1953 of the Board of Governors that the reduction in margin requirements in February of that year was justified because by that time "inflationary pressure had moderated" (p. 88).

as to policies which should have been employed, calls for more detailed examination of the problem of measuring the effects of monetary policies.

A great deal of attention has been directed in recent years to the alleged "rediscovery of money." Growing confidence in the effectiveness of orthodox monetary policies contrasts sharply with the preceding attitude of doubt which was a heritage of the depressed years of the 1930's. It resembles in many respects the extreme confidence in Federal Reserve policies which featured the decade of the twentieth.

The question of the effectiveness of monetary policy is important not only on grounds of simple scientific accuracy. Some judgment as to the effects of particular instruments of control is presumably necessary in order for them to be utilized to proper advantage. Even more important is the thought that to underestimate their effectiveness may be to deprive the economy of benefits which they can confer while to overestimate their effectiveness may lead to the disregard of other techniques and so deprive the economy of a second line of defense in case they prove inadequate for some future emergency.

The difficulty of measuring the effectiveness of monetary policy arises out of the fact that the actual course of business developments is influenced by underlying conditions as well as by the policies employed at any particular time. Underlying conditions may change. How, then, is one to determine how much of the altered course of business developments following a change in monetary policy was the result of these measures and how much was the result of the change in underlying conditions? This is, of course, a familiar difficulty in the realm of social science.

Two illustrations will help to show how changes in conditions complicate the analysis of monetary policy. The period from the middle of 1952 to April 1953 was one in which the Federal Reserve, according to its published statements, was following a restrictive policy. It was also a period in which member bank borrowing from the Federal Reserve averaged between 3 and 4 times that of the preceding year. This is exactly the opposite of what would be expected to occur as the result of a more restrictive policy: Restriction would be expected to be accompanied by a reduction, not an increase, in the volume of member bank borrowing. It is presumably to be reconciled with the Board's claim that its policies were restrictive on the grounds that conditions had changed so that in the absence of the Federal Reserve restraints even greater credit expansion would have occurred. A less kindly interpretation would be that it showed that the restrictions were less effective than is contended and that the relatively stable economic conditions prevailing generally were attributable to other factors than monetary policy. Clearly there is no sure way of determining which interpretation is correct.

The second example is even more paradoxical. The Federal Reserve lists net sales and redemptions of Government securities amounting to $800 million from January to April 1953 as restrictive but it lists net sales of $900 million of Government securities from January to June 1954, as expansive.[15] In other words, the same phenomenon is given as restrictive in one instance and expansive in another. On the face of things, such statements appear thoroughly contradictory. The

[15] Hearings of 1954, p. 14. Cf. supra, p. 27, n. 2.

explanation apparently intended is that seasonal factors released reserves automatically to a much greater extent in the second period so that by limiting sales to only $900 million, abundant reserves were still available to promote expansion. The sales of $800 million in the previous year were apparently so large in relation to reserves then released by seasonal factors that member banks remained under pressure for reserves and the net effect was, therefore, restrictive.

There is no apparent ground for questioning this interpretation or for challenging the wisdom of the actions taken by the Reserve authorities, but it is reasonable to draw a moral: If a change in conditions could cause a particular course of action to be restrictive at one time and expansive at another, then such changes could surely be so great as to be the determining factor in changes in aggregate demand. Obviously, therefore, great caution must be exercised in ascribing a causal influence in the determination of business activity to any particular course of monetary policy or, indeed, to monetary policy in general.

The plain fact is that, with a few possible exceptions, the precise effects of central bank policies are not capable of proof. It is simply not possible to demonstrate conclusively whether a given change in the volume of credit is the cause of a change in business activity or the change in business activity is the cause of the change in the volume of credit. It is entirely conceivable that at one time causality may run in one direction and at another time in the opposite direction. The same sort of uncertainty attaches to the relation between changes in interest rates and changes in the volume and distribution of credit.

In reviewing monetary policy after the Treasury-Federal Reserve accord, it may be assumed that any of three interpretations is possible. The first is that the monetary policies were not responsible for conditions that prevailed from 1951 to 1956 but rather that these favorable conditions were the result of nonpolicy influences and would have existed in the absence of the measures taken, even though these measures may have been correct according to accepted standards. The second possibility is that monetary policy was, in fact, largely responsible for the favorable course of business developments from 1951 to 1956, but would not have been equal to the pressures and disturbances that prevailed from 1945 to 1951 [16] and may not be equal to tests that may arise in some future period. The third possibility is that monetary policy was a decisive factor in the course of events from 1951 to 1956 and that it can be counted on to meet any future needs. This conclusion amounts to saying either that monetary policy was important all along and that the period of its eclipse in the thirties and forties was a simple case of falling into error, or that the conditions which prevailed in those years may have been unsuited to the exercise of monetary policy but that conditions are now favorable, and can be counted on to continue favorable, to the pursuit of monetary policies as a stabilizing technique.

There is clearly no way of determining which of these three possible assumptions comes nearest to the truth. Reasonable men will differ as to which of them is to be preferred. But on one point all must agree: The only course that eliminates risk of disillusionment is to

[16] The latter is substantially the position taken by Professor Hansen in the article quoted earlier (supra, pp. 23 sq.). In the same article he quotes Allan Sproul, president of the Federal Reserve Bank of New York, in support of this contention.

accept the view that the actual effectiveness of monetary policy is uncertain. By doing so we can hope to have alternative courses of action ready in case they are needed for some future contingency.

Prof. W. A. Morton of the University of Wisconsin has suggested that for the purposes of central bank policy it is not necessary to be able to predict the exact effect of a particular policy in order to justify its use. He quotes John Stuart Mill as having said that knowledge which is insufficient for prediction may be extremely useful for guidance. The point is surely well taken. It leads to the conclusion that central bank policy should be used as fully as the authorities see fit and that prevailing confidence in particular policies should be allowed full scope to vindicate itself. But at the same time it suggests that other instruments should be kept in reserve just in case the more optimistic hopes are not fulfilled. So long as it is recognized that precise prediction as to the effectiveness of particular policies is impossible, it may be expected that alternative courses of action will be held in readiness.

4. The problem of objectives

At one time it would have been generally agreed that the primary goal of monetary policy was maintenance of a fixed relationship between domestic currency and a given weight of gold or, what amounts to the same thing, a constant exchange value in terms of other currencies on the gold standard. At times attempts were made to extend and adapt the idea of monetary stability to include the maintenance of a stable level of commodity prices in terms of some standard index. In recent decades, the goal of monetary policy has assumed broader proportions. By the middle of the 20th century the paramount objective of monetary policy, for most countries of the world, including the United States, had generally come to be regarded as the maintenance of business activity, or full employment as technically defined.

The period under review will be found to have shown substantial progress toward the crystallization of a further objective of central bank policy, that of facilitating growth. Even if this were nothing more than a clearer recognition by monetary authorities and students of central banking of the growth element which is present in the concept of full employment, it would be of considerable importance. But it is much more than that and amounts to setting up a further objective of monetary policy.

If one were to characterize the essential nature of a central bank in a single word, it would probably be that of stabilizer. The focus of stabilization policy has shifted from time to time over the years as is indicated by the varying attention given to gold movements, exchange rates, price level, employment, and economic growth. The period since the depression of the thirties has seen the Government security market come within the range of central bank stabilization efforts. Moreover, central bank policy has been concerned increasingly with plural objectives, reflecting the desire to achieve more than one type of stability. Central bank policy will doubtless continue to be concerned with problems of stabilization. It is to be expected that degrees of emphasis on particular aspects of stability will vary, that techniques will undergo change, and that particular objectives will frequently come into conflict with one another.

It is unfortunate that while each of the familiar goals of monetary policy is desirable they are likely to come into conflict one with another. Monetary authorities are certain, therefore, to be confronted with the uncomfortable necessity of choosing among various desirable objectives or of effecting some sort of compromise among them. Pursuit of one goal is certain to involve the sacrifice of other goals. To compromise may well lead to the use of apparently contradictory methods. The authorities will then find themselves exposed to criticism on grounds which may be valid even though incomplete.

Whatever the perplexities to which it inevitably subjects the authorities, monetary policy must nevertheless be thought of in terms of plural objectives rather than of a single paramount goal. The problem is certain to be one of effecting a balance among objectives, even though the price of making progress in one direction is to fall somewhat short in another direction. Thus the attempt by the Federal Reserve to maintain orderly conditions in the security market was bound to make it more difficult to promote stable prices but was not necessarily to be condemned on that ground alone. It is to be expected that just as monetary objectives have undergone change in the past so objectives that seem important today may appear less important at another time or in the eyes of different individuals.

The existence of multiple goals implies the utilization of multiple policies. In the period after the Treasury-Federal Reserve accord the tendency to concentrate on use of the general instruments of credit control was hardly to be interpreted as constituting a permanent change in policy. It was rather an indication that the country was in a stage where economic conditions were such that monetary objectives and policies could be thought of in simpler, more orthodox terms that those that had prevailed a few years earlier. It is reasonable to expect that future changes in business conditions or other complications could again alter the main focus of objectives as well as the nature of instruments regarded as appropriate to the carrying out of monetary policy.

5. The problem of guides to central bank action

Difficulties that apply to economic policy in general with respect to the proper guides or signals to be followed apply also to monetary policy. There are similar questions as to the reliability of particular indexes of prices or production; as to their timeliness, that is, how great a delay there is in their becoming available; and as to how predictive they are, that is, whether they are indicators of future developments and not merely measures of what happened in the past. There is the important question of relevance, that is, their applicability to matters with which central bankers are concerned.

Apart from these general questions, there is the problem of what to do when accepted signals disagree. To illustrate: Between the middle of 1953 and the middle of 1954, unemployment in the United States rose by nearly 2 million at a time when the monetary stocks of gold were declining by $600 million and prices, wholesale and consumer, were practically constant. Thus the first signal called for policies of greater ease, the second for tighter policies, and the third

for no change at all.[17] It is apparent, as Dr. Bopp points out, that this example can just as well be looked upon as a conflict of objectives touched upon in the preceding section. An alternative line of attack might be to define objectives only in the very broadest terms, such as promotion of economic stability. Under such a terminology, exchange rates, prices, or full employment would cease to be thought of as objectives and would assume the status of guides only. A comparable example is the possible conflict between internal and international stability which attracted the attention of many writers, Keynes among them, in the 1920's and which is involved in more recent discussions of a return to convertibility.[18]

A still more perplexing problem arises out of the fact that the same signal may mean different things at different times. Thus growth of inventories because fabricators and distributors are trying to stock up, as happened early in the Korean war, is a sign of inflation, but growth of inventories because demand has subsided and manufacturers and distributors are finding it impossible to maintain sales at existing prices, as happened in 1953–54, is a sign of deflation. Similarly, economists have sometimes called attention to the contrasting significance of a rise in interest rates which reflects an increase in optimism and one which reflects an increase in pessimism (hope inspired and fear inspired).[19]

An equally confusing situation arises when a permanent change occurs in the meaning of particular guides or in their applicability to the purposes for which they have been used. The Palmer rule and the real bills doctrine were perhaps never as fully valid as some of their supporters maintained. The greater probability, however, is that they were reasonably useful at one time but, with a change in economic conditions, lost contact with the real world and therefore their usefulness as guides to policy. The usual situation is not that theorists or administrators originate positive error; it is rather that generalizations are drawn which have relevance only in relation to particular circumstances. In the course of time, conditions change and the generalizations cease to be valid but they continue to command the allegiance of the orthodox on the ground that they are time-tested and proved economic laws.

Dr. Bopp has said: "The acid test of a guide is not the internal consistency of the logic or model on which it is based, but experience."[20] To the extent that casuality can be proved, which is likely to be extraordinarily difficult, experience may, perhaps, be accepted as a test of the past effectiveness of a guide to policy. Experience can never, however, be a proof of its future effectiveness. Past experience may even be positively dangerous. To the extent that past confirmation leads to a false sense of security concerning future conditions which are different, its contribution is negative. The lesson to bear in mind is not that we learn nothing from history but that

[17] This example is from Karl R. Bopp, "The Rediscovery of Monetary Policy—Some Problems of Application," Federal Reserve Bank of Philadelphia, Business Review, August 1955, p. 5.

[18] See Roy Harrod, The Financial Times, London, July 19, 1955, p. 7.

[19] A somewhat different example is the preservation of price stability in the face of falling real costs of production. Such a situation is alleged to have existed in the United States during the 20th. The absence of price level change was currently interpreted, in line with conventional assumptions, as signaling stable economic conditions when actually it should have been regarded, because of the decline in costs, as having inflationary connotations.

[20] Bopp, op. cit., p. 8.

frequently we learn too much, or the wrong things, from history. We should take our history mixed with a strong dose of relativity, that is, relativity to the conditions which prevailed in the past and in the present.

The moral of these remarks is not that signals for the guidance of monetary policy are of no avail. It is rather that no signal or combination of signals should be allowed to harden into a rule of thumb. Signals, always subject to interpretation to prevailing conditions, are a necessary adjunct to the making of decisions. But they cannot be allowed to do the deciding themselves. Discretion, or discernment, is the indispensable ingredient of policy.

6. The problem of confining open-market operations to short-term securities

In the period after the accord the liveliest issue relating to the technique of credit control turned on the question of confining open-market operations to dealing in short-term securities. This is, of course, merely one aspect of the general question of the choice of techniques to be employed in carrying out monetary policy. After 1951, the still broader questions of whether or not to use fiscal policy, direct controls, and selective credit controls retreated into the background or narrowed to the possibility of future application. The problem of current interest was whether the Reserve banks should buy and sell Treasury obligations of all maturities or only those of shortest term, namely, 90-day bills.

The case for confining operations to the short end of the market was clearly stated by the Board of Governors: "In the first place, the risk assumed by professional intermediaries when they trade in bills is much less than when they trade in longer term securities. Bills are traded on a discount basis, and the great preponderance of bills outstanding at any one time have a maturity of less than 3 months. This means they will always appreciate to par within that period. Bills are ideal collateral, furthermore, and can always be used as security for loans * * * The main financial hazard attending professional operations in bills is that the holder will have to pay more in interest when he borrows to carry them than they gain in price as they approach maturity. Another reason is that the bill market is accustomed to relatively large transactions such as the open-market account must undertake in absorbing and releasing reserves. It is the market in which all financial institutions typically adjust their day-to-day positions. Trading is continuous * * * Finally, the financial markets do not attach the same significance to System operations when they are transacted in bills as they do to transactions in other sectors of the market. Financial experts know that the Federal Open Market Committee is more or less continuously engaged in putting funds into of absorbing funds from this market as it compensates for large day-to-day fluctuations in the amount of float, in Treasury balances, in the demand for currency, and in other factors. The appearance in the bill market of purchase or sell orders initiated by the Federal open-market account has no general long-term policy significance in the great majority of cases, and therefore does not so readily give rise to apprehensions that a change in policy is imminent." [21]

[21] Hearings of 1954, pp. 19 sq.

The stand taken by the Board was largely, it would seem, a carry-over from the situation which prevailed before the accord when the Government bond market was felt to be unduly dependent on the Federal Reserve support policy. The issue of a free as against an artificial market for Government bonds will be examined later in more detail. It may be remarked here, however, that President Allan Sproul, of the Federal Reserve Bank of New York, favored greater latitude with respect to dealings in securities of different maturities.[22]

A second objection to the "bills only" rule is that it amounts to a partial abdication by the central bank of one of its important functions. Private flotations have the benefit of underwriting support. It is argued that one of the primary functions of the central bank should be to provide comparable support in the flotation of Treasury obligations.[23] In the words of President Sproul: "If Treasury debt-management operations put a temporary but intense strain on the facilities of the market * * * the largest single portfolio of all should not always stand aloof (except for the purchase or sale of Treasury bills). Direct aid in helping to cushion the effect of massive maturities, new issues, or conversions of Treasury securities * * * would seem to me to be wholly consistent with the primary demands and objectives of monetary policy." [24]

He denied that such a policy involved constant intervention in the market or the pegging of prices. He quoted the Governor of the Bank of Canada in support of his position: "The Bank of Canada has been a constant trader in Government of Canada securities since we opened our doors in 1935 * * * We have endeavored to help make a market for all Government issues and have been very substantial buyers and sellers. In a sense, we perform a jobbing function, holding the inventories which are indispensable to a good market." [25]

In agreeing with the Open Market Committee that its policies should be reflected in the cost and availability of credit, he declared that "* * * this concern can find its best expression, at times, in open-market operations specifically directed at * * * longer term markets." [26]

Critics of the policy argued, first, that dealings in longer term securities could be a useful instrument, often citing Keynes' support of this contention.[27] It was pointed out that changes in capitalized values have come to be regarded, by Federal Reserve experts as well as by others, as an important feature of credit operations. The capitalization effect of changes in interest rates is strongest and most direct in the case of long-term issues. Sensitiveness of the market to dealings in long-term securities by the Reserve authorities, instead of being a disadvantage as the Board suggested, was interpreted as the very reason why they could be so effective if judiciously employed.

Finally, it may be objected that any hard and fast rule is an undesirable limitation upon the freedom of the central bank. It is gen-

[22] The Board did not close the door completely to dealings in longer term securities. Such dealings, however, were endorsed only under conditions of extreme disturbance in the market.
[23] Hansen, op. cit., p. 111.
[24] Allan J. Sproul, Central Banks and Money Markets, New Jersey Bankers Association, Atlantic City, May 6, 1954, p. 5 (mimeographed).
[25] Sproul, op. cit., p. 5.
[26] Hearings of 1954, pp. 225 sq.
[27] John Maynard Keynes, The General Theory of Employment, Interest, and Money, London, 1936, p. 206.

erally agreed that an essential feature of central bank policy is flexibility. From that standpoint, this or any other relatively inflexible rule would be objected to. A rule such as this is unnecessary to dealing in short-term securities whenever the Open Market Committee finds it desirable to do so; but it is an obstacle to freedom of action (flexibility) in case the Committee should find a different policy to be called for at any time in the future. Mr. Sproul expressed concern that Federal Reserve authorities were "* * * in danger of placing ourselves in a straitjacket which would not permit us to accomplish what the Congress and the public might expect us to accomplish in terms of monetary management." [28]

The Board has taken the position that impulses originating in the market for short-term securities are quickly transmittted to other parts of the Government bond market through the operation of free market forces. But if the market mechanism is this easy and smooth, it would seem to follow, on the ground that the effects would be quickly transmitted elsewhere, that the Federal Reserve could equally well enter the market at any point. The logic of the Reserve's position is evidently that significant lags do exist in the transmission of the effect from one point of the Government bond market to another. This being so, the case for maintaining freedom to enter the market other than at the short end would seem to be strong.

The firm stand taken by the Board of Governors for confining open-market operations to securities of the shortest term appears to reflect conceptions which derive from a period when the public debt was relatively small and which may have lost much of their validity in today's world of greatly expanded public debt.[29] The market for Government bonds has so changed its size and character from what it was in the past that traditional presumptions of the conditions of supply and demand in that market are no longer to be depended upon. While the conclusions drawn from the earlier presumptions are not necessarily invalidated by that fact, the change in circumstances surely calls for their careful reexamination.

As was noted above, the yields on Government obligations have fluctuated widely in recent years. Between 1952 and 1956 the price of long-term Governments was more unstable than the price of second-grade corporate bonds. Such a situation is completely contrary to historical precedent. It is here tentatively suggested that fluctuations of this character are a reflection of fundamental changes in the financial structure of the economy, and more specifically that the Government security market has been rendered inherently unstable primarily because of the portfolio operations of commercial banks.

Formerly, call loans were the principal medium for adjusting the reserve position of commercial banks. It is Government securities that now chiefly perform this function. Commercial banks are today the largest holders of Governments. Moreover, commercial-bank holdings of Treasury obligations fluctuate to a greater extent than those of any other group. This helps to explain why there is strong prima facie evidence that the purchase and sale Governments by commerecial banks contributes to variations in the supply and demand of Treasury obligations and thereby to fluctuations in yields on Government securities. (See chart 2.)

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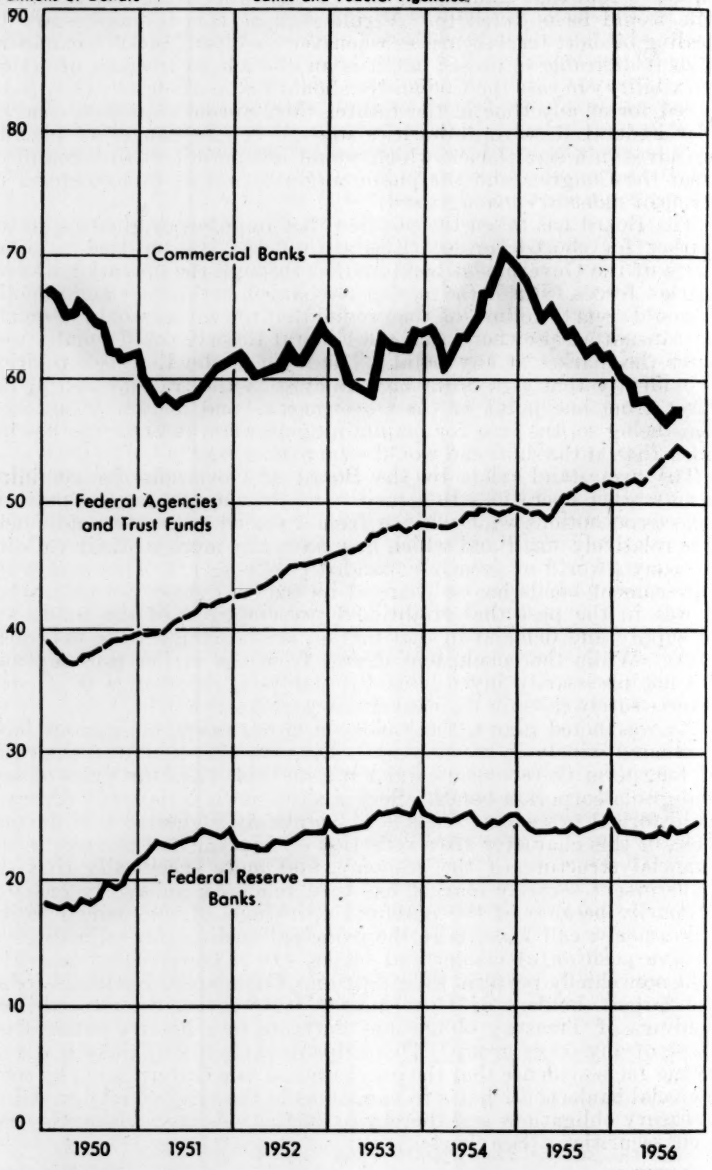
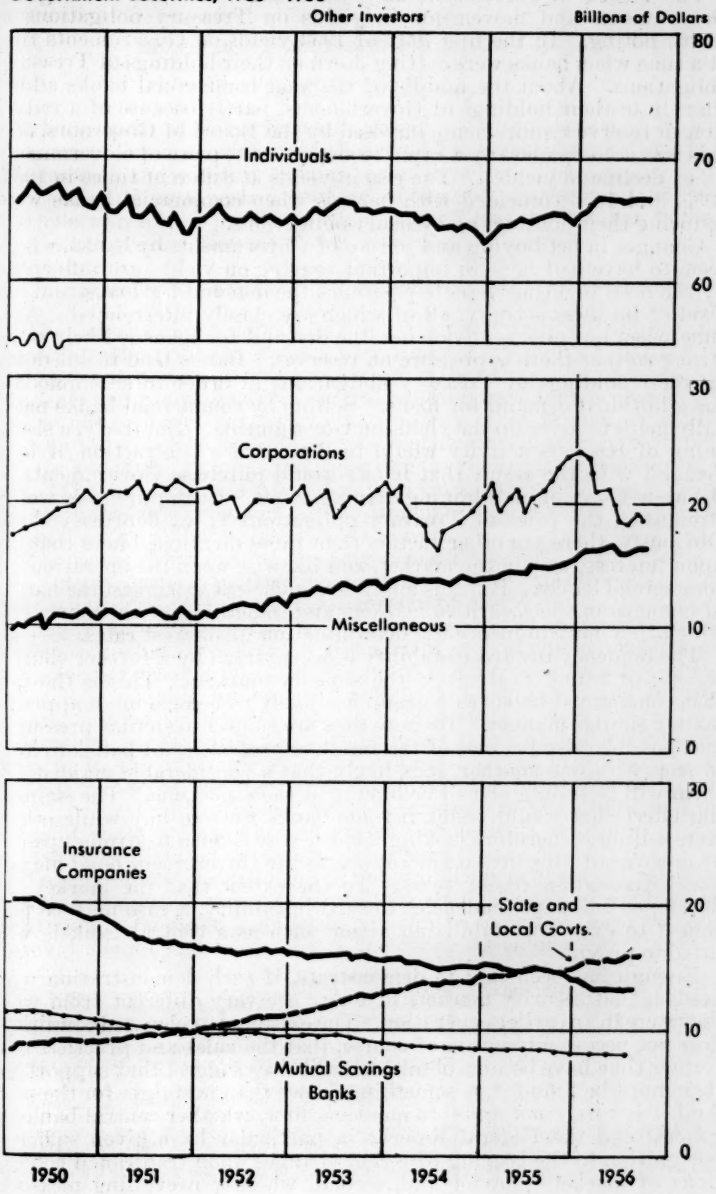
[28] Hearings of 1954, p. 225.
[29] Ervin Miller, Monetary Policy in a Changing World, The Quarterly Journal of Economics, vol. LXX, Cambridge, Mass., 1956, pp. 23 sqq.

Chart 2 – Ownership of U. S. Banks and Federal Agencies.



[1] *Source:* Board of Governors, *Federal Reserve Charts,* December 1956.

Government Securities, 1950–1956[1]



The record of correlation between changes in bank holdings of Governments and movements in yields on Treasury obligations is worth noting. In the first half of 1953 yields on Governments rose at a time when banks were cutting down on their holdings of Treasury obligations. About the middle of the year commercial banks added sharply to their holdings of Governments, partly because of a reduction in reserve requirements imposed by the Board of Governors, and this was accompanied by a rapid recovery in the price of Governments (i. e., decline in yields). The rise in yields at different times in 1954, 1955, and 1956 coincided with periods when commercial banks were reducing their holdings of Treasury obligations.

Changes in net buying and selling of Governments by banks, which seem to have had such an important bearing on yields, are influenced by the need to adjust reserve positions, the demand for loans, and the level of business activity, all of which are closely interrelated. At a time when business is advancing, the demand for loans is likely to be strong so that there is pressure on reserves. Banks tend to cut down on their holdings of Treasury obligations in order to accommodate the additional demand for loans. Selling by commercial banks naturally helps to drive up the yields on Governments. Similarly, a slackening of business activity would tend toward a contraction of loan demand with the result that banks would purchase Governments as the easiest way of maintaining earning assets. Such purchases would strengthen the price of Treasury obligations (i. e., depress yields). Obviously, there are other factors than those mentioned here that act upon interest rates in the market, and likewise upon the operations of commercial banks. But this analysis is sufficient to suggest the nature of changes in the securities markets and something of the manner in which they may influence the determination of interest rates.

The tendency toward instability is accentuated by a further characteristic of banks' dealings in the security markets. This is the fact that commercial banks as a group are likely to behave in an approximately similar manner. Because they are subject to similar pressures, and possibly also because of the familiar propensity of banks to keep in step with one another, it is likely that a considerable majority of them will be selling or will be buying at the same time. The stabilizing effect that would result if some banks were to buy while others were selling is therefore lacking and the way is open to strong upward or downward pressures on price such as the Government bond market has witnessed in recent years. To the extent that the market has developed inherent tendencies toward instability, a case may be presumed to exist for stabilizing action such as a central bank is well fitted to provide.

Enough has been said to demonstrate, if such demonstration were needed, that security markets of today are very different from what they were in an earlier generation. The existence of changed conditions does not necessarily mean, of course, that the rules and practices of a former time have become obsolete, but it does suggest that support for them must be founded on something firmer than nostalgia for the past. And it is surely not amiss to question, first, whether central banks in general and the Federal Reserve in particular have given sufficient recognition to the bearing of recent changes upon traditional conceptions of market behavior and, second, whether prevailing measures are properly adapted to meeting the problems that are certain to be encountered in a world of enormously expanded public debt.

[Reprinted from the Review of Economics and Statistics, vol. XXXIX, No. 1, February 1957]

Monetary Policy and Economic Change

By C. R. Whittlesey

The purpose of this article is to examine certain aspects of Federal Reserve policy in relation to the bearing of various changes which have occurred in the economy during recent decades. The discussion will be concerned first with a number of current issues and later with various unresolved problems which are of less topical, but perhaps somewhat greater theoretical, interest.

I. Adaptation of Monetary Policy to Changing Conditions

The description of politics as "the art of the possible" applies likewise to public policy in general and to monetary policy in particular. To say that central banking is an art rather than a science, as both students and practitioners of central banking have been accustomed to do, is not to deny that, in this as in every other branch of applied economics, scientific methods and a scientific attitude can be extraordinarily fruitful. But the fact does remain that central banking is an art. The principal weakness of central bankers lies not in any failure to recognize that fact but in deciding what constitutes the possible when it comes to the application of their art.

The main difficulty confronting central bankers is that what is possible for central bank policy is in no sense an absolute. It is not that what is possible is merely a matter of expediency, although expediency undoubtedly has to be considered; the policymaker who disregards what is realistic is only a little less ridiculous than the one who forgets what is ideal.[1] The more baffling consideration is that what it is possible for central banking to accomplish, and by what means, is relative to many things. These include such internal considerations as the objectives to which it is committed, the guides available to it, the instruments at its disposal. They also include such outside factors as the state of the economy, the international climate both political and economic, and the attitude of the public. While some of these endogenous and exogenous elements are subject to accurate determination or control, others clearly are not.

To suggest that the problems of the practitioners of the art of central banking is difficult is not to imply that they do as good a job as can legitimately be asked. A better job can be expected, however, only through heightened sensitivity to the changing environment in which

[1] A former member of the Board of Governors once privately defended his failure to vote for more vigorous measures on the following grounds: More positive action would have been likely to provoke strong criticism in certain quarters. As a consequence, Congress might have been induced to interfere with the Board by imposing restrictions or revoking authorizations previously conferred. Better to retain powers which they do not use than to run the risk that, by using them, so much opposition would be built up that the powers would be taken away. While the utility of having powers which are not employed may seem somewhat obscure, it can be argued that a greater emergency might sometime arise in which they would be put into effect. The same official was opposed to efforts to add to the Board's powers even on a standby basis for fear that Congress would interpret this as a bureaucratic grasping for power and, far from extending the Board's controls, would react by curbing or removing some of those already at the Board's disposal. It is not possible to prove that this line of reasoning is wholly mistaken. But it clearly rationalizes a policy of inaction and makes a virtue out of weakness. All this in the name of realism.

central bankers operate and increased willingness to modify central bank actions in the light of these changes. And it is highly probable that the pressure to effect these adaptations will have to come mainly from students of the art who are outside the system itself.[2]

Free versus artificial markets

In the period after the Treasury-Federal Reserve accord the Board of Governors embraced the ideal of free security markets with great zeal. "Maintenance of orderly conditions" as the announced policy goal gave way to "prevention of disorderly conditions," and this in turn to "correction of disorderly conditions." The last of these formulations signified that the Federal Reserve authorities would refrain from action except to remedy a situation which had already proceeded too far. The stand taken by the authorities gave evidence of hardening into the doctrinaire attitude that there was no tolerable intermediate position between laissez faire and a rigid commitment to support Treasury obligations at par such as had existed before the accord.

A possible compromise, one consistent with practices followed in other markets, would have been to differentiate between interference which is likely to produce a more, and that which is likely to produce a less, ideal market. The latter (and undesirable) type of interference would include actions designed to hold prices more or less continuously at levels different from a long-run normal. The former (and presumably desirable) type of interference would include actions designed to restrain excessive deviations from that norm. The deviations would be assumed to be excessive if they were clearly based on rumor, speculation, or temporary abnormalities of supply and demand, especially if the fluctuations appeared to be of a self-inflammatory character. To admit that it would sometimes be difficult to determine whether price movements were of one character or the other is not to agree that they would never be clearly distinguishable. The fact that orderly marketing provisions have been introduced in other markets is a recognition that completely free operation of supply and demand is not synonymous with ideal markets.

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[2] Professional economists and other students of central banking have the advantage that they are relatively free from the political pressures to which central bankers are subject. In the nature of things, also, they are a more inquiring, nonconformist breed of men. They are not immune, of course, to the human tendency to rely unduly on relatively short-run perspectives. One may recall the remark by Professor Ohlin to the effect that British economists tend to derive their theories from the events of the recent past (The Problem of Employment Stabilization, New York, 1949, 161).

A striking example of changing beliefs with respect to central banking has to do with the effectiveness of monetary policies in combatting inflation and deflation. In 1930 Keynes declared that it was easier for the monetary authorities to combat deflation than inflation (Treatise on Money, vol. II, 253). This conclusion was presumably influenced by the strong inflationary pressures loose in the world during the preceding years. Under the influence of deflationary conditions in the 1930's precisely the opposite opinion came to prevail. Attempts by central bankers to overcome deflation were likened to pushing on a string. Even though the contention may have possessed validity at the time, it amounted to the substitution of analogy for analysis. If the figure of a rod is put in place of the figure of a string the force of the argument disappears. The point is not that the rod analogy is valid and the string analogy false. Rather it is that the one may apply at one time and the other at another time.

It remained for the inflationary conditions after World War II to bring about a return to the position advanced a quarter of a century earlier by Keynes. The Economist of London remarked in its issue of October 29, 1955 (p. 363) on the prevailing but "still unproven view that bank rate is very much less effective in conditions of rising production than of falling prices."

The fault with both generalizations about controlling inflation or deflation by monetary means is that they leave out of account the bearing which the state of the economy has on the effectiveness of monetary controls. In the years after World War II we may have had a situation where Keynes' view approached much more closely to the truth than it did in the 1930's—though not, it may be said, for the reasons given by Keynes.

The foregoing analysis rests on the assumption that when the authorities interfere with free market forces their intervention will be discerning and moderate. Opposition which the Board of Governors expressed to intervening in the securities market was based on the assumption that its interference would be undiscriminating and arbitrary. Reference was made to "the constant possibility of official action, which from the standpoint of investors and market intermediaries would often seem capricious" and to "the danger that operations by the Federal open-market account may, *if executed through faulty techniques*, exert an unduly disturbing or even disruptive effect upon the market for United States Government securities." [3] It was said that not only are open market sales made from a huge portfolio held by the Reserve banks but "for all the market knows, they may be the forerunner of many more sales to come." [4]

If the Federal Reserve were to act capriciously, on impulse, or in a faulty manner and without reliable statistical information, the conclusion would no doubt follow that "transactions initiated by the Federal open market account, particularly transactions in intermediate issues, may seriously affect the efficiency of the market." [5] But the entire history of the Federal Reserve indicates that it can be counted on to act carefully, with circumspection, and on the basis of full analysis of factual information. Past actions of the Board may be open to the criticism of undue caution but never of caprice. The general tenor of the Board's comments from which these quotations were taken goes far beyond the limits of official modesty. It amounts to a declaration of responsibility. Comparable examples of self-slander must surely be rare in the history of central banking.

The opinion has frequently been expressed that Treasury and Federal Reserve officials were unrealistic in suggesting that the market for Government securities can be thought of independently of actions taken—or not taken—by the Federal Reserve.[6] When the Federal Reserve changes the amount of available reserves it clearly alters an important element in the supply of and demand for Government securities. At different times the price of Government securities has changed for no other reason, apparently, than rumors of an impending change in the level of reserve requirements. And the bond market was never more clearly influenced than by what was interpreted as the announcement of a policy of noninterference by the Federal Reserve in the spring of 1953.

The Board's opposition to artificial markets in Government securities was one phase of the countrywide impatience with restraints which followed the experiences of the war period. Their opposition was strengthened by recollections of uncomfortable moments which the Board had endured while rigid pegs were being maintained. Questions still remain as to whether the Board distinguished as clearly as it might have between different types of interference and

[3] Hearings before the Subcommittee on Economic Stabilization of the Joint Committee on the Economic Report, December 6 and 7, 1954 (Washington, 1954), 16 and 17. [Italics supplied.] Hereafter referred to as 1954 hearings.
[4] Ibid., 19.
[5] Ibid., 20.
[6] An analogy drawn by Secretary of the Treasury Humphrey, wherein he likened the market for Government bonds to the market in which a farmer's wife sells eggs, was the target for enthusiastic ridicule by Senator Douglas and others. See 1954 hearings, 207; and Joint Committee on the Economic Report, hearings on the President's Report (Washington, 1955), 428–37.

whether it underestimated the skill and success with which an intermediate policy might be pursued and overestimated the tendency of moderate interference to degenerate into rigid support.

A dilemma exists, in that freedom of the market, strictly construed, is inconsistent with freedom of the central bank. It is the purpose of a central bank to achieve a more ideal market, which is not identical under all circumstances with a freer one. Any hard and fast rule is a limitation on the freedom of the central bank to maintain the flexibility which is essential to central bank policy. The "bills-only rule," whereby open-market operations were confined to Treasury bills, and which was part of the paraphernalia for achieving a free and broadened market for Government securities, was unnecessary for dealing in short-term securities whenever the Open Market Committee found it in the public interest to do so. But it was an obstacle to freedom of action (flexibility) in case the committee should at any time find that a different policy was called for. Allan Sproul, then president of the Federal Reserve Bank of New York, stated the issue very clearly when he warned that the Federal Reserve authorities were "in danger of placing ourselves in a straitjacket which would not permit us to accomplish what the Congress and the public might expect us to accomplish in terms of monetary management."[7]

Changed character of the bond market

It may be suggested that the firm stand taken by the Board of Governors on the issue of confining open-market operations to short-term securities implied a "small debt approach" to its responsibilities which may be inapplicable to the world of today.[8] Is the idea of refraining from suporting action at a time of Treasury borrowing realistic in a situation where Treasury financing has assumed present-day proportions? Can the Federal Reserve undertake to remain aloof from the bond market when the marketable debt amounts to $230 billion with the same assurance as when it was one-tenth that amount?

The price of Government bonds has fluctuated widely in recent years. Between 1952 and 1956 the price of long-term Government bonds showed wider fluctuations than the price of second-grade corporate bonds. Such a situation is as foreign to historical precedent as it is to normal expectation. It can only signify a considerable change in the character of the bond market. This conclusion does not prove that conventional policies are mistaken; nevertheless, it suggests that caution should be exercised in assuming that conventional policies are correct for conventional reasons.

The increased instability of the Government security market appears to be largely a result of the portfolio operations of commercial banks. Today, Government securities occupy the place once held by call loans as a medium for the adjustment of reserve positions by commercial banks. Commercial banks are the largest holders of Treasury obligations, and fluctuations in the magnitude of these holdings are sharper and wider than in any other group of holdings. It is reasonable to suppose, therefore, that changes in buying and selling by commercial banks are an important cause of changes in the demand and supply of Government securities and thus of fluctuations in the yields of Governments.

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[7] 1954 hearings, 225.

[8] Cf. Ervin Miller, Monetary Policy in a Changing World, Quarterly Journal of Economics, LXX (February 1956), 23–28.

This hypothesis is supported by examination of what happened to bank portfolios in different periods when the interest rate on Government bonds was changing. We find, for example, that the rise in yields in 1953 took place at a time when commercial banks were reducing their holdings of Government securities. The turnabout in yields at the middle of the year coincided with a sharp rise in commercial bank holdings of Governments, a rise made possible in part by the reduction in member bank reserve requirements. The rise in yields in late 1954 and early 1955 and again later in 1955 and 1956 occurred at times when banks were lightening their portfolios of Governments. In explaining what lies behind the actions of commercial banks in increasing or decreasing their holdings of Governments, a major factor to be considered is the demand for commercial loans.

It may now be tentatively suggested that the sequence of events is somewhat as follows: At a time when loan demand is strong and additional reserves are not readily forthcoming from the Federal Reserve or elsewhere, commercial banks are likely to cut down on the volume of Governments they hold in order to facilitate an expansion of loans. The selling of Governments by banks tends to force their prices down (yields up). Conversely, at a time when business is slackening, loans begin to decline, and banks, with the resources thus made available, turn to Governments as the simplest means of maintaining the volume of earning assets.[9] The effect of this buying by the banks is to drive up the price of Government securities (lower yields).

The foregoing analysis is obviously simplified. It takes no account of the maturity distribution of bank portfolios of Governments, and it ignores other holders of Government securities. Its purpose is to emphasize, even at the risk of overemphasis, the importance of commercial bank dealings in the Government bond market. But this is only part of the story. There is the further fact that commercial banks as a group are likely, in the very nature of things, to behave in a roughly similar manner. If some were selling while others were buying, the market would not have the same tendency to be unstable. But because they are subject to similar motivation and possibly because of a certain propensity toward following the leader,[10] there is a tendency for the majority of banks to be selling or buying at the same time. Thus the way is open to strong upward and downward pressures such as may account for the fluctuations in the Government bond market in recent years.

Even apart from the interpretation presented here of new and potentially destabilizing forces in the Government security market, it is clear that the existence of a large national debt, distributed as it is with respect to ownership and maturities, constitutes a distinct contrast with the economic conditions that existed before World War II. The question this poses is whether the prevailing attitude of the Board of Governors, with its insistence on aloofness and on confining its operations to the short end of the market, has taken suffi-

[9] Other influences such as a change in reserve requirements may also affect their dealings in Governments.

[10] This similarity of behavior is partly a characteristic of banker psychology and not just a reflection of the leadership provided or pressure exerted by the central banking authorities. It is distinct also from the group response remarked upon by Keynes in the Treaties on Money in his famous analogy with party behavior (tipsiness and sick headache). The similarity referred to here has manifested itself repeatedly at times, such as during the 1930's, when reserves were redundant and to all intents and purposes banks were independent of monetary restraints.

cient cognizance of the change that has thus transpired.[11] Or does the small-debt philosophy still linger on in a period that is conspicuous for the great size to which the debt has grown?

II. UNRESOLVED PROBLEMS

The "locking-in" effect

The view has come to be widely accepted among both lay and professional followers of central banking that permitting a decline in the price of Government bonds is an effective means of preventing their sale, particularly by institutional investors. This alleged deterrent effect is sometimes referred to as a blocking-in effect or liquidity trap. The reasoning proceeds from the fact that insurance companies and other institutional and noninstitutional investors hold large amounts of long-term securities. Some of these securities, notably Governments, are treated as relatively liquid assets as long as they are selling above cost. As long as their price remains relatively high, they can be sold without loss or, conceivably, with a capital gain. If a decline in the bond market were to cause them to fall below cost, selling would entail a capital loss. Recognition of such loss in an accounting sense can be avoided by holding on to the securities as long as they are selling below cost. In the case of such safe securities as Governments, it is always assumed that final redemption will be at par or above, so that the abstention from selling involves no significant risk.

The essence of the argument is the contention that investors are extremely reluctant to accept capital losses through sale of securities below cost. It is assumed, therefore, that a decline of security prices below par[12] will "lock in" the holders of long-term securities, i. e., induce them to refrain from further selling. Action of the central bank in tightening money rates, i. e., depressing the bond market, is thought of as having the effect of "springing" the liquidity trap.[13]

The popularity of this argument among Federal Reserve experts and students of central banking, as well as businessmen, is sufficient indication of its persuasiveness. Unfortunately, the record has contradicted the theory upon various occasions. Following the Treasury-Federal Reserve accord, for example, the sale of governments by life insurance companies, far from decreasing, rose with the decline in

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[11] Official recognition of the point made here was given in testimony by Mr. Martin in 1956. The Open Market Committee's departure from strict adherence to the bills-only policy a few months before was defended on the ground that moderate purchases of intermediate securities might make it possible to avoid larger purchases of bills and thus result in a smaller net creation of reserves (hearings on the President's Report, 1956, p. 302). This was a significant endorsement of views advanced earlier by various economists.

[12] This is a minor oversimplification. Strictly speaking, the argument should be confined not to declines below par but rather to declines below cost. This will vary, of course, for different holders. The same possibility of loss would arise not only at sales below par but also in cases where bonds, bought at a premium and not yet amortized down to par, are sold at prices above par, conceivably considerably above. Likewise, if securities were acquired below par they could also be sold below par without any book loss necessarily resulting. The essential point is the effect of a decline below the price at which the securities appear on the owner's books.

[13] The alleged effectiveness of rising yields as a deterrent to the selling of governments is discussed at some length in the Patman documents, Monetary Management Policy and Debt, Part I, 363–68. Cf. also Albert G. Hart, "* * * holders could be frozen into bonds * * * by permitting yields to rise somewhat." American Economic Review, XLV (May 1955), 410. That similar views prevail abroad may perhaps be inferred from the following quotation from A. B. Ilersic, Government Finance and Fiscal Policy in Postwar Britain (London, 1955), 190. "Unless severely pressed, few individuals or institutions will liquidate securities at a loss, so that during a period of low bond prices, neither borrowers nor lenders will be active."

prices of Government bonds. This failure of statistical evidence to conform to alleged expectations was either ignored or attributed to special circumstances. Occasionally it was suggested, rather lamely, that the increase in sales of Governments at this time would have been even greater if the liquidity trap had not exerted a restraining influence. A better explanation of the failure of the statistical record to corroborate the theory is that the theory of a locking-in effect rests upon an incomplete analysis of the motivations which underlie investor behavior. More specifically, the argument as customarily advanced underestimates two important considerations which influence the actions of the managers of investment portfolios.

In the first place, the argument leaves out of consideration other developments occurring in the market at the same time. A drop in the market price of Government bonds is equivalent to a rise in their yield. If this were the only change taking place it would indeed provide an inducement for holding on to Governments. But if at the same time the yield on other types of securities were to rise even more, the spread in yield would thereby have widened; consequently, there would be more inducement than before to sell Governments in order to take advantage of the greater spread in yield through appropriate switches. Thus the argument as usually presented makes the mistake of looking on the level of yield on Governments rather than the spread between this and other available yields as the factor which governs the profitability of selling Governments or holding them.

The argument also abstracts from the bearing of very important tax considerations. A company may deliberately choose to establish a capital loss as a means of effecting a tax saving through charging the loss off against a capital gain elsewhere. This is a further, and at the present time a highly important, consideration bearing on the net gain to the investor from holding onto its Governments or from shifting, even with a capital loss, to some other investment.

In the second place, the argument fails to make allowance for expected future movements of security prices. It is highly unlikely that a decline from 100 to 98 will be effective in preventing sales if it is expected that the price will shortly drop to 96. And if the initial decline gives rise to an expectation that a further drop is likely to occur, it will have precisely the opposite effect from that which is customarily assumed. In such a situation, selling helps to drive prices down, thus confirming the negative expectations and contributing to the expectation of further declines. This is precisely what happened in the spring of 1953. It was not the low level of prices reached at that time that brought an end to the downward movement of bond prices, but indications of a change in policy by the Federal Reserve. When it became apparent that the Federal Reserve was prepared to intervene, the public quickly jumped to the conclusion that the bottom of the market had been reached. Expectations of a decline gave way to expectations of a rise in bond prices. These expectations, in turn, stimulated the market actions which tended to confirm and strengthen the expectation of rising quotations for Government bonds.

Expectations are a powerful influence in the bond market. At various times in recent years, expectations have been fed and price

behavior influenced by rumors of changes in reserve requirements and discount rates and by reports concerning the rate about to be set on new borrowing by the Treasury.

The trouble with the locking-in generalization is its oversimplification of investor behavior. No theory, after all, is any better than the assumptions on which it rests. This particular theory rests on much too narrow a conception of the motivations of institutional investors. In particular, it assumes that their actions are governed to a decisive extent by the desire to avoid book losses. Such losses are admittedly a consideration. But investors are also affected by other considerations. These other considerations, moreover, may be far more influential in determining the actions of institutional investors than mere book loss.

The shortcoming of the theory of the locking-in effect is that it disregards other significant factors. It is readily demonstrable, for example, that failure to sell at a book loss, as in situations such as those indicated above, may result in a lower net gain than could otherwise be obtained. In other situations as well, sole regard for book losses would conflict with the desire of investors to maximize net return. Old fashioned economic theory was by no means perfect. But surely a theory which starts from the assumption that the desire to maximize net is of primary importance in the actions of businessmen is more to be trusted than theory such as this that rests on far flimsier and more ephemeral assumptions.[14]

The flexibility-inflexibility paradox

When interest rates were allowed to rise in 1952–53 a sharp contraction in the volume of new lending on VA and FHA mortgages immediately followed. This experience has frequently been referred to as a classic demonstration of the effectiveness of flexible money rates. A little analysis will show that it demonstrates nothing of the sort. What happened was that the rate allowed on such mortgages remained frozen while other rates were allowed to rise. The prevailing pattern of yields was thus distorted, with the yield on guaranteed mortgages far below, relatively speaking, the yields on other types of investment. The flow of investment into mortgages was reduced, presumably as a consequence of this differential in yields.

The restrictive effect on the volume of mortgage credit resulted not from the rise in rates per se but from the combination of a fixed rate on guaranteed mortgages and rising rates elsewhere. It was the reflection not of genuinely flexible interest rates but of a discriminatory policy, with some rates flexible and some fixed. The paradox is that the effectiveness, as an instrument of credit control, of the flexibility of interest rates which were allowed to move was conditioned upon the inflexibility of other rates which were prevented from moving.

The net effect of this combination of flexible and inflexible rates was somewhat analogous to the operation of selective credit controls.

[14] The foregoing is not intended to suggest that there is nothing whatever in the view that a fall in price may act as a deterrent to selling. If price were to fall so rapidly or go so low that a significant and early recovery were strongly indicated, investors would perhaps be encouraged to hold on. This is just another application of the point noted above that expectations are an important factor in investment decisions. It would still be necessary, however, to take into account what was occurring elsewhere in the market. At best the locking-in idea is a half truth which, through continued repetition, has gained undue acceptance. It is as though it were assumed that a half truth twice told becomes a whole truth.

Theoretically a similar result might have been achieved by lowering the rates on guaranteed mortgage credit alone while other money rates remained unchanged. The main conclusion to be drawn from the 1952–53 experience with mortgage credit, therefore, is that it appears to illustrate the effectiveness of discrimination, not of flexibility, in the management of money rates.

The "insurance money" paradox

In the spring of 1953, at a time when interest rates were rising sharply, the chief investment officer of a large insurance company remarked to a friend that officials from a certain industrial concern were coming in to obtain some "insurance money." This, he explained, was his name for borrowing which was based merely on a desire to make sure that possible future needs were covered at rates no higher than those then prevailing.

Borrowing designed to protect the borrower against the possibility of a further rise in interest rates may at times make use of standby agreements, that is, commitments to lend at stipulated rates of interest. A small charge (one-eighth to one-half percent per annum) is ordinarily made until the option is either exercised or canceled. At other times it takes the form of borrowing a larger sum than is required or of borrowing earlier than would normally have been the case.

In its annual report for 1953 the Board of Governors reported a large increase in capital flotations in May and June of that year "partly reflecting the fear that funds would be harder to obtain later on" (p. 94).[15] An officer of one of the Federal Reserve banks reported a New York financier as having declared that he knew personally of borrowing amounting to over $600 million which was pushed forward from the third quarter to the second quarter of 1953 for no other reason than to protect against having to pay higher rates than were then available.

To what extent the stimulus thus given to borrowing offsets or conceivably outweighs the restrictive effect of the higher cost of borrowing entailed in the rise of money rates is impossible to determine.[16] It is not difficult to demonstrate that higher rates have contributed upon occasion to the postponing of borrowing operations or even to their cancellation. It is no less true, however, that individual cases can also be found like those just mentioned where borrowing operations were advanced or induced. On the face of it there is no way of determining which tendency, if either, predominates. It is important to recognize, however, that the common disposition to assume that the restrictive influence outweighs the stimulative influence may merely reflect the particular brand of static supply-and-demand analysis on which most of us have been brought up.

By examining totals one can observe whether the net change in the volume of credit was up or down following a rise in money rates, but this does not prove what the effect of the restrictive action was: We still do not know what would have occurred in the absence of the

[15] Cf. the statement by Richard Youngdahl, of the research staff of the Board of Governors, that in the spring of 1953: "Credit demands remained intense but part of the demand was not for immediate use but in anticipation of needs by borrowers who wished to be certain their future requirements would be covered." *American Economic Review*, XLV (May 1955), 406.

[16] The possibility that borrowing may be stimulated in the manner indicated does not necessarily mean, of course, that there will be a similar effect on real investment.

measures taken. If total outstandings increased it is possible that they would have increased even more in the absence of the rise in rates, so that the influence of the higher rates was genuinely restrictive. But it is also possible to argue that a decline in total outstandings is likewise no demonstration of restrictive effects since the decline might have been still greater without the rise in rates.

Savings effect of interest rate changes

The preceding example related to the manner in which a change in interest rates may induce shifts in the schedule of demand for credit and thereby tend to counteract the effect which a change in interest rates is ordinarily assumed to have on the demand for credit. The next point relates to somewhat similar offsetting tendencies with respect to the effect of interest rate changes on saving and thereby presumably on the supply of credit.

Let us assume that a rise in interest rates is the result of central-bank action designed to promote economic stability and also that the public believes that such a rise will contribute appreciably toward attainment of that goal. If we accept the further assumption that one of the important motives for saving is uncertainty, e. g., that people save in order to provide for a rainy day, we immediately find ourselves involved in a paradox. A reduction in pessimistic expectations because of the stabilization activities of the central bank may lessen the incentive to save. To the extent that consumption is encouraged by the assurance afforded by the central bank, the result is to offset the restrictive effect which the rise in interest rates is presumed to have on investment,[17] thereby tending to sustain income and expenditures at existing levels.

The capitalization paradox

Renewed interest has come to be directed toward the transmission of the effects of interest rate changes by way of the capitalization of assets. Higher rates accompany lower prices of long-term bonds and other fixed income assets. A decline in the prices of these assets is alleged to have a chilling effect on the spirits of the people, since no one relishes the sight of a shrinkage in the market value of his assets. Thus higher interest rates go with a fall in the prices of real estate, bonds, and the like:[18] this with greater pessimism and caution; and these with a reduction in the demand for new investment.

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[17] The presumption of a restrictive effect on investment may also be open to challenge under the circumstances indicated. It can hardly be supposed that the marginal efficiency of capital will remain unchanged if the rise in interest rates increases public confidence in the future stability of business. Profit expectations would presumably be raised and the risk of loss diminished because of the lessened probability of fluctuations in prices and employment. The correspondingly greater inducement to invest may be expected to strengthen the demand for credit, tending to offset the restrictive effect on investment which results from the higher cost of borrowing.

The point both here and above is that confidence in the ability of the central bank to accomplish its objective may tend to destroy the validity of the reasoning whereby the ability of the central bank to accomplish its objectives is ordinarily explained. (In many situations, of course, confidence in the ability of the authorities to accomplish their aims is favorable to their attainment.) This is not to suggest that public confidence in central-bank policy is disadvantageous but that it may call for modification of the explanation of how monetary policy operates, as well as for modification of the techniques actually employed.

[18] The question of causality between interest rates and capital values is rather intricate and cannot be entered into at this time. The statement sometimes encountered (even in high places, as witness the Annual Report of the Board of Governors of the Federal Reserve System for 1954, p. 6), that an increase in yields causes a decline in the price of long-term securities is, of course, simple nonsense. Clearly the rise in yield and fall in price is merely an identity. The only way a decline in yields on Government bonds can manifest itself is by a fall in their price, and likewise whenever the price of Governments falls this constitutes a rise in the rate of yield on them. On the other hand, Professor Hansen has

Let us suppose, however, that weakness in the bond market encourages a shift out of bonds into stocks, both directly and through the channeling of new funds into stocks, rather than bonds.[19] And assume that the natural consequence of this redirection of investment funds is to contribute to buoyancy in stock prices. What of the possible stimulative effect of this on public psychology? Will the push of the stock market neutralize, or perhaps even overbalance, the drag of the bond market?

That this question is far from hypothetical is indicated by the fact that the two periods of notable heaviness in bonds, 1952–53 and 1955–56, were periods of ebullience in stocks. We can always retreat, of course, to the easy conclusion that the higher rates helped, at least, to control the stock market boom, i. e., that, even though the desired contraction did not materialize, the expansion might have been even greater without the increase in interest rates. Here again, however, we are up against conjectural history, and the probability is strong that preconceptions and past indoctrination will influence our final opinion.

It is not possible to say which influence of those mentioned here may be expected to exert the greater effect. But surely it may properly be suggested that there is need for caution in drawing easy conclusions from the capitalization idea and likewise that there is need for further study of the entire question.

A similar note of questioning and caution also applies generally to central-bank policy.[20] The simple fact is that precise conclusions are impossible on most matters in this area. Not only do other factors almost invariably enter in, but with changing economic and psychological conditions responses are seldom twice the same. The moral is plain that central bankers require a full complement of instruments and a flexible approach to their problems. This is the one sure conclusion that can legitimately be drawn.

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offered the observation that while this reciprocal relationship may be accepted as applying to bonds and mortgages, it should hardly be regarded as applying to all types of capitalized assets. In the case of real estate, for example, it may be correct to say that higher interest rates are the cause of a fall in real-estate values. The distinction obviously merits consideration, but is not essential to the present discussion which is confined to the market for bonds and stocks.

[19] The possible causal relationship is expressed in this form since the present discussion is concerned with a rise in interest rates (fall in the price of bonds) initiated by the central bank for the purpose of curbing stock-market activity. The rise in discount rates in April 1956 was acknowledged by Federal Reserve officials to be motivated by such considerations. In terms of market behavior it could be argued that a shift from bonds to stocks is likely ot occur not because bonds are weak but because stocks are strong. A rise in stock prices because of the expectation of higher earnings in a period of boom may induce a shift from bonds to stocks and thereby contribute to the higher level of interest rates which tends to characterize the latter phases of expansion.

[20] The foregoing discussion by no means exhausts the subject of unresolved problems, either as to their number or as to what might be said about them. Moreover, other problems are certain to crop up from time to time. During the period of tight money in 1956–57, for example, frequent mention was made in Federal Reserve publications and elsewhere of the tendency for higher interest rates to induce more active turnover of money. This suggests that the restraining influence which the general instruments of credit control purportedly exerted through limitation of the quantity of money was at least partially offset by the stimulus given to its rate of use.

Contemporary comment on the rise in velocity emphasized similiarities in the effect of changes in the volume and the rate of use of money as far as prices and incomes are concerned. It failed to call attention to the fact that an expansion in the volume of circulating medium may be presumed to involve the purchase of Treasury obligations and other credit instruments by banks whereas an increase in velocity does not. It is in accord with the analysis presented above to offer the opinion that this difference may constitute a significant reason for past and prospective swings in interest rates.

FORD MOTOR CO.,
Dearborn, Mich., May 31, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: Enclosed is my statement in response to your questionnaire on the financial condition of the United States. I am most grateful for the extension of time you kindly granted me.

Sincerely yours,

THEODORE O. YNTEMA,
Vice President, Finance.

SENATOR BYRD'S QUESTIONNAIRE, FEBRUARY 17, 1958

Question 1. Give a definition in your own words of deflation and inflation.

Answer. Inflation and deflation have various meanings. For the purposes of this discussion I shall define them as follows:

Inflation—The phenomenon of rising prices.

Deflation—The phenomenon of falling prices caused by a decline in demand.

There are two main types of inflation: (1) demand-pull inflation, in which there is an increase in the volume and/or velocity of money and in which demand tends to outrun supply; and (2) cost-push inflation, in which there is upward pressure on wage rates and/or the prices of other factors of production, even though labor and materials are not in short supply. Cost-push inflation is usually accompanied by an increase in the volume or velocity of use of money, but this need not be the case if the cost-push inflation occurs in a recession. In actual experience we do not get pure cases of demand-pull inflation or cost-push inflation. Nevertheless, some inflations have their origin primarily in an expansion of demand and others in a rise of costs.

In this connection, it is worth noting that cost-push forces will accelerate and aggravate a demand-pull inflation. If labor and business are swift to raise wages and prices on the least pretext, and if wages and material costs are subject to automatic escalators, a bulge in demand and a rise in prices in part of the economy will spread rapidly through the rest of the economy, producing a much more rapid upward spiral of prices and costs than otherwise would occur.

A decline in the price level may be due to a falling-off in demand or to a decrease in costs made possible by improved productivity. When the decline in prices is caused by reduction in demand, this phenomenon is deflation. On the other hand, a price decline caused by lowered costs and increased productivity is not properly termed "deflation." Deflation—a decline in prices caused by falling demand—is accompanied by a contraction in the money supply or a reduction in the velocity of money use, or both.

Question 2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.

Answer. A money and credit economy, producing durable goods in large volume, will have cumulative tendencies toward inflation and deflation. These tendencies cannot be curbed entirely without seriously impairing individual initiative, freedom of action and economic progress. They can, however, be kept from developing into severe booms and depressions. The most important means to this end are:

(1) A money and credit system that will not collapse and will provide adequate liquidity in depression. In such a system the money supply can be expanded in depression and contracted in boom times if necessary.

2. High enough credit standards so that a large volume of forced liquidation of loans and bad debts will not develop in a recession.

3. Automatic stabilizers, such as pay-as-you-go taxes and unemployment insurance, that not only tend to stabilize incomes but also tend to increase incomes in relation to the supply of goods and services in depression and decrease incomes in relation to the supply of goods and services in boom times.

(4) A central banking system that will restrain the expansion of money and credit in boom times and that will ease credit and increase the money supply in depression.

(5) Management of the public debt so that it does not thwart the contracyclical action of the central bank.

(6) Sufficient competition in labor and in business so that cost-push inflation will not push up the price level when demand is restricted by monetary and fiscal means.

(7) Fiscal action to reduce tax rates temporarily in depression if monetary measures are not adequate to deal with the situation.

(8) In time of genuine emergency, such as at the outbreak of war, quick application of price and wage controls.

On all these counts, except one, our institutions and know-how, though far from perfect, are adequate to give us a fair degree of economic stability. And we could achieve even greater stability if we would translate the technical economic knowledge we possess into appropriate action.

The one essential condition for stability that is lacking is sufficient competition in labor and in business to avoid cost-push inflation. This lack will, I believe, be fatal to economic stability unless it is remedied.

At present we have in business, outside the regulated public utilities, competition that varies a good deal in its character from industry to industry. This competition is not "perfect" in the technical abstract sense of economics which assumes for each market a large number of buyers and sellers, perfect knowledge on the part of buyers and sellers, costless transportation and communication, no unattained economies of scale, instantaneous adjustment of capacity to demand and independence of action by each buyer and seller. Competition in business is not perfect either in the everyday sense: it can be and needs to be improved. By and large, however, there is enough competition in most industries to keep prices and profits down to levels roughly equal to

those necessary to compensate for the risks of the business. The tradition in business is competition. And there are laws on the books prohibiting monopoly and monopolistic practices—laws that have maintained reasonably workable competition in business.

A different situation exists in labor. Labor unions are monopolies established under the aegis of law. They are given special protection and even immunities and privileges that are not accorded ordinary citizens. They are not subject to much regulation or restraint in the use of their monopoly power.

During the boom of 1955–57 and in the recession of 1957–58 the unions have displayed their power to drive up wages faster than productivity and to squeeze profit margins. There is no reason to expect different behavior in the future from labor unions unless their powers are reduced. We can look forward, therefore, to continued and probably accelerated cost-push inflation in the future unless appropriate action is taken.

This problem cannot be cured by monetary or fiscal means. Prof. E. H. Chamberlin makes this point clearly in "The Economic Analysis of Labor Union Power."

"To deal with a wage-push inflation by monetary or fiscal policies is certainly not to deal with causes; it is rather an attempt to create a counter push by squeezing businessmen so that they will in turn squeeze labor. It risks economic contraction, to say nothing of major industrial strife. An obvious alternative is to diminish the degree of economic power in the hands of the unions, so that the pressure may be reduced at its source." [1]

Nor can this problem of labor monopoly and cost-push inflation be solved merely by increasing the degree of competition in business. The less able an industry is to pass on increased costs in higher prices, the easier it is for organized labor to encroach on the profits of that industry in the short run. Reduced profits, however, mean reduced investment, retarded growth, and increased unemployment. We shall still be left with the dilemma of either validating wages that outrun productivity by increasing the money supply, expanding demand and establishing a higher price level, or else suffering unemployment.

Industrywide organization of business to oppose industrywide organization of labor is not a happy solution. Although industrywide bargaining tends to equalize the economic power of business and labor, the results are unpredictable and often injurious to the economy. On the one hand, business may yield too easily to the union demands, knowing that if wage costs rise all firms will be affected equally. Or the opposite may happen: Unable to settle the issues peacefully, the parties may resort to economic warfare with an industrywide shutdown and heavy losses to employees, stockholders, others dependent on the industry and the public at large.

Wage and price controls are still worse as a solution to cost-push inflation. Wage and price controls will breed so much economic dislocation and inefficiency that they will impede and even stop economic progress. Before long such controls will break down because of administrative difficulties, evasion, and noncompliance.

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[1] Labor Unions and Economic Policy, p. 29. (The American Enterprise Association, 1958.)

The only satisfactory way to prevent cost-push inflation induced by the monopoly power of unions is to reduce that monopoly power.[2] As a first step, some or all of the legal immunities of labor can be removed, and unions can be made subject to the laws of the land that ordinary citizens must obey. (See Roscoe Pound, Legal Immunities of Labor Unions.[3]) The removal of the special immunities of labor unions may accomplish much of the reduction in the economic power of unions that is needed to prevent cost-push inflation.

If this first step is not sufficient, the second step would be the development of antimonopoly laws for unions and analogous to the antimonopoly laws for business. If necessary, it would be possible to limit federations of locals for collective bargaining to a size that does not give them monopoly control of labor and wages in an industry and to prohibit collusion among such federations in economic matters. It may not, however, be necessary to go this far to prevent most wage inflation.

The problem of wage inflation is relatively new. It began to emerge in the thirties, but it did not appear clearly until the boom and inflation of 1955–57 and the recession of 1957–58. Not only is the problem new, but it is beset by taboos and strong emotional reactions. What is needed is objective analysis of wage inflation and labor monopoly by competent, disinterested scholars and the publication of their findings. As economists in increasing numbers undertake such analysis, as the economic profession becomes better informed, and as the knowledge spreads to the public, there will develop a basis for action in dealing with labor monopolies. At this stage I would not urge specific legislation other than reduction in the special privileges and immunities of unions. Beyond that, I would urge continued investigation of the labor monopoly problem in educational institutions, in research organizations, and in Government so that we may have, as soon as possible, a foundation in technical knowledge and in public opinion for appropriate action.

Question 3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942 to 1957. (You may wish to divide the period into two parts: 1942–50 prior to the accord, and 1951–57.)

Answer. The monetary policy of the Federal Reserve System from 1942 through 1950 appears to have had three objectives:

(1) To supply a sufficient amount of money to the Treasury to enable it to finance the war.

(2) To keep the level of interest rates low in order to minimize interest costs to the Treasury.

(3) To provide ample credit and low-interest rates in order to maintain a full-employment economy.

From 1942–50, the Federal Reserve System appeared to be operating under the strong influence of the Treasury Department. The national emergency during the war period necessitated, to some degree, this subservient role. On the other hand, the inflationary pressures during the postwar period required restrictive credit policy rather than support of the Govenment bond market. It must be remembered, however, that

[2] For an excellent discussion of this problem see Statement of Edward H. Chamberlin before the Subcommittee on Labor Relations, Senate Committee on Labor and Public Welfare, May 22, 1958.

[3] The American Enterprise Association, Inc., Washington, D. C.

economic opinion at that time indicated the probability of the usual postwar recession and that credit policy was dedicated to the prevention of such a development. By 1947, however, the Federal Reserve System should have been concerned more with restricting inflation than preventing a business decline.

With the "accord" in 1951, the Federal Reserve System was no longer hamstrung by the commitment to support Government bonds. Since then, the System has used its powers to restrain inflation and mitigate cyclical fluctuations. I would commend the System for its courage and its wisdom, but at the same time I would offer these suggestions in regard to its recent actions.

With hindsight, it is apparent that restrictive monetary measures were continued too long in 1957 and that the increase in the rediscount rate in August 1957 was inadvisable. I am inclined to think, too, that the steps in recent months to ease credit might well have been taken more quickly.

At present, loans are obtainable by good credit risks, but interest rates to borrowers are still high. Bank-loan rates and long-term bond rates are considerably above the levels prevailing prior to 1955. It would be greatly in the public interest to increase the reserves of commercial banks and/or reduce their reserve requirements further in order to exert more downward pressure on sluggish interest rates.

Question 4. Beginning in August 1956 there was an increase in the Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

Answer. From March 1956 to December 1957 the BLS Consumer Price Index rose 6 percent. The BLS Wholesale Price Index started rising after mid-1955 and was 7.4 percent higher by December 1957.

This increase occurred across the board in practically all categories of commodities and was not concentrated in any particular group of commodities.

During this period there was no sudden bulge in demand and there were no important shortages of consumer goods and services. In general, productive capacity was adequate to supply the demand for consumer goods, raw materials were readily available, and, through the labor supply was somewhat tight, it was possible to increase production where needed.

The only important segment of the economy where demand pressed on available resources was in producers' capital goods and construction from mid-1955 to the end of 1956. The aggregate Wholesale Price Index is influenced substantially by these items and thus moved up earlier than the Consumer Price Index. For commodities common to both the Wholesale and the Consumer Prices Indexes, the timing and extent of price rise were similar.

In the period of general price rise from the second quarter of 1955 to the fourth quarter of 1957, total corporate profits after taxes (exclusive of profits from inventory price change which are not included in total national income) did not rise and then declined sharply in the last quarter of 1957, showing a decrease over the period of $2 billion. Unincorporated business and professional income was up about $1 billion and farm income was virtually unchanged. Employee compensation, on the other hand, increased $34 billion.

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In recent years wage rates plus fringe benefits continued to rise at a rate of 5 to 7 percent per year, while in the last 2 years output per manhour outside of agriculture rose about 1 percent a year. Wages outrunning productivity raised costs and consequently prices, and at the same time provided higher money incomes to pay the higher prices.

The conclusions from this and other economic evidence are:

(1) The increase in consumer prices in 1956–57 was attributable primarily to the increase in wage rates in excess of the increase in productivity.

(2) The increase in consumer prices was not attributable to a bulge in demand or to shortages in supply.

(3) The increase was not attributable to a bulge in corporate profits.

(4) The increase was general and was not attributable in particular to price increases on products of large corporations.

There follow some notes on the increases in the major subdivisions of the Consumer Price Index since March 1956.

Consumer services account for a third of the index and are supplied for the most part by unincorporated business, by utilities subject to rate regulation, and by nonprofit institutions. They increased in price by 6.7 percent from March 1956 to December 1957. This was on top of a 12.6-percent rise from December 1951 to March 1956, during the period when other consumer commodity prices leveled off or declined. (See exhibit: "Consumer Price Index—Commodities and Services.")

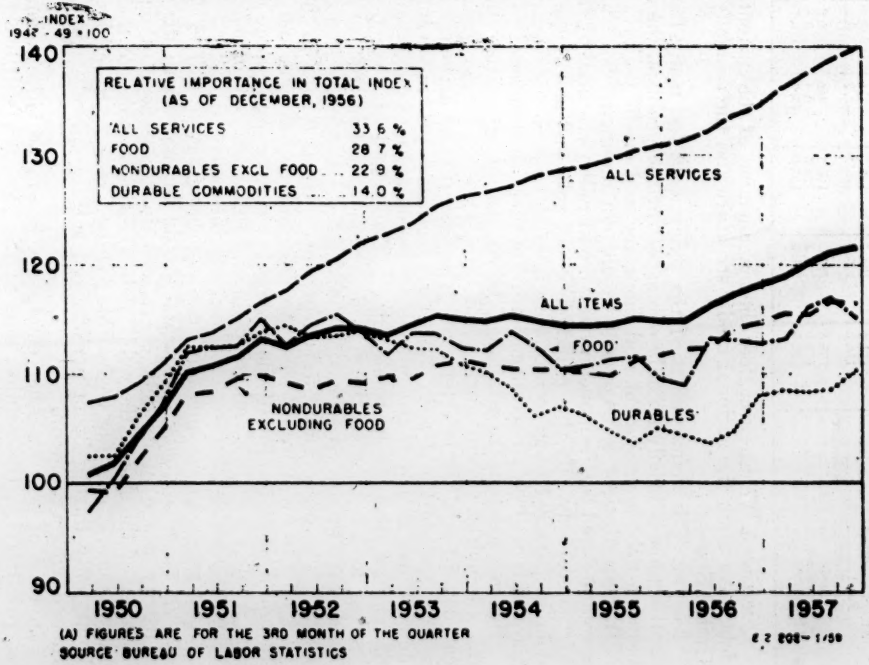
Foods, which currently account for about 29 percent of the index, contain a small amount of corporation profits in the consumer price. Most of the difference between retail and farm prices represents transportation, labor cost of manufacturing, and distribution. Transportation and distribution costs increased primarily because of higher labor cost. Food prices rose 6½ percent between March 1956 and December 1957. These prices only slightly more than recovered the decline after December 1951.

Nondurable commodities other food account for an additional 23 percent of the index. The largest segment of this group represents apparel, the production and distribution of which does not reflect high profits of large corporations. The textile and apparel industry, on the contrary, is usually plagued with low profits. Apparel prices increased 2.6 percent from March 1956 to December 1957. Prices of other consumer nondurable commodities rose 5.9 percent during this period. The rise in apparel prices merely recovered the decline after December 1951, but the increases for other nondurables was in addition to a rise of about 6½ percent from December 1951 to March 1956.

The other element of the Consumer Price Index—consumer durable goods—has a weight of 14 percent of the total index. Prices of consumer durables increased 5.8 percent from March 1956 to December 1957. Despite the recent rise, these prices were still nearly 3 percent below the December 1951 level.

QUESTION 4—EXHIBIT

CONSUMER PRICE INDEX—COMMODITIES AND SERVICES[A]



(A) FIGURES ARE FOR THE 3RD MONTH OF THE QUARTER

SOURCE: BUREAU OF LABOR STATISTICS

	December 1951	March 1956	December 1957	Percent change		
				1951–56	1956–57	1951–57
All items	113.1	114.7	121.6	1.4	6.0	7.5
All commodities	112.4	108.5	114.7	−3.5	5.7	2.0
Food	115.0	109.0	116.1	−5.2	6.5	1.0
Nondurables (excluding food)	109.8	112.1	117.3	2.1	4.6	6.8
Durables	113.9	104.3	110.3	−8.4	5.8	−3.2
All services	116.5	131.2	140.0	12.6	6.7	20.2

Question 5. What effect does the management of the current public debt have upon the national credit structure and the economy of the United States?

Answer. The management of the public debt has many facets. I shall comment briefly on only one aspect of the problem, the conflict between debt management and monetary and credit policy.

In general, debt management should not dominate, but should be accommodated to, the monetary and credit policy required by the state of the economy. If this principle is not followed and if the public debt is managed so as to minimize interest costs to the Government, the result will be an accentuation of cyclical fluctuations.

Interest costs can be minimized by concentrating the debt in short-term securities except during a depression when longer-term issues can be sold at a low interest rate. The first of these actions, carrying a large part of the debt in short-term securities, provides a huge volume of near-money that can be easily converted into money and used to increase demand in boom times. The second of these practices, issuing long-term maturities in depressions, siphons off investment funds that might go to business and thus increase the demand for goods. The observance of such policies without regard to their impact on the cycle would serve to intensify depressions and booms. It would make the job of the central bank accordingly more difficult and would result in a real loss of income to the economy much greater than the possible gain from reduced interest costs.

As a general principle, the Treasury should try to extend the debt during an inflationary period and should concentrate in the shorter maturity range in its debt operations during periods of deflation. Because of the size of the public debt and the problems of marketing huge issues, it may not be feasible for the Treasury to sell long-term bonds only during boom periods and refrain entirely from selling them during a recession.

In time of war or other emergency when the Government must borrow heavily, the requirements of the Treasury will override the anti-inflationary policies that would otherwise be appropriate for the Federal Reserve System. In such circumstances, every possible effort should be made to borrow on long maturities and from sources outside the banking system so as to minimize the expansion of the money supply and the inflationary effects of deficit financing.

Question 6. (*a*) Discuss in their relationship to one another and according to your judgment of their relative and importance, the following three objectives of economic policy in the United States:

1. Price stability.
2. Stability of production, demand, and employment.
3. Economic growth in production, demand, and employment.

(*b*) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II—during the most recent 2 or 3 years—and especially during 1957.

Answer. Price stability, stability in production and employment, and economic growth are all important objectives of economic policy.

Stability of the general price level is important for two reasons. First, it is necessary if we are to avoid arbitrary levies on, or windfalls to, debtors, creditors, persons with fixed incomes, and persons with flexible incomes. Ideally, the price level should decline gradually as productivity rises, so that all sectors of the economy may share in the benefits from increased productivity. Second, sufficient price stability is required so that money will serve as an acceptable store of value, and so that plans, decisions, and financial arrangements can be made satisfactorily in regard to business operations extending over months and years.

In this connection it should be noted that stability in the general price level does not imply rigidity or a high degree of stability in the prices of individual goods and services. Individual prices should be sufficiently flexible to draw resources into the employments where they will be most productive and to provide a balance between demand and supply.

Stability in production and employment is important for a number of reasons. Production that is lost in depression reduces the standard of living and retards the accumulation of capital needed for economic growth. Depressions and unemployment cause personal hardships and foster dissatisfaction and resentment. These often lead to attempted remedies that are injurious to the economy. It should be noted that stability in production and employment in each industry is not to be expected. There will be, and should be, expansion and contraction in specific industries in response to shifts in demand. Furthermore, the effects of general business fluctuations are not wholly injurious; a recession creates the need for increased efficiency and economy and these, in turn, contribute subsequently to more rapid economic growth.

Growth in production should be the major goal of economic policy. Our rising standard of living is, of course, dependent on such growth. Economic growth has its roots in improved education, scientific research, engineering development, better organizational and administrative techniques, incentives (especially profits), and the accumulation of capital. The principal hazards to economic growth are war, inflation that interferes with the function of money as a store of value, and impairment of economic incentives by monopolistic practices, by state controls and by too-high taxation of profits and incomes.

In general, it is unwise to sacrifice economic growth in any substantial degree for increased stability. The benefits of increased stability are for the most part temporary, but the benefits from economic growth are cumulative and permanent.

Among the important trends since World War II, the high rate of growth in production and the attendant high rate of accumulation of capital, are noteworthy. To some extent these represent recovery from the long preceding period of depression and war.

The last 12 years have been notable, too, for stability of production and employment. In part this stability reflects the prolonged

demand for durable goods to build up inventories of such goods to desired levels. In part it reflects the action of automatic stabilizers and the decreased sensitivity of our money and credit system to depression influences.

The period since World War II has not been one of price stability. Nevertheless, the snuffing out of the postwar inflation in 1948 was a notable achievement of one of our most important automatic stabilizers, the pay-as-you-go tax system. At the peak of the inflation the system produced a $10 billion cash surplus in 4 quarters without any increase in tax rates. The spurt in prices that occurred in 1950 with the outbreak of the Korean war could have been checked by the immediate imposition of price and wage ceilings. Most of these controls could have been relaxed at an early date when the surge in demand subsided.

The most ominous instability of prices since World War II developed in 1955-57 and continued into 1958. During this period the rise in output per manhour slowed down markedly. Nevertheless, wage rates and fringe benefits continued to rise at a rapid rate, much in excess of productivity. The result was increased costs, increased prices, and reduced profit margins. In 1956–57 the Federal Reserve System tightened credit, thus dampening the demand for goods and services. In 1957–58, a substantial recession developed but wage rates and consumer prices continued to rise.

These developments are ominous because they indicate that wages will probably continue to outstrip productivity, thus causing higher costs and higher prices (in turn, to be validated by monetary expansion). If such price increases continue, they will injure still further people with fixed incomes. Moreover, the inflationary trend will tend to accelerate as more and more groups try to anticipate it and protect themselves against it by escalation. The result may well be an inflation and a profit squeeze that will threaten economic growth and stability of production and employment.

Question 7. Give your opinion of the effect on our economy of current Federal, State, and local government spending.

Question 8. Give your opinion of the effect on our economy of current Federal, State, and local taxation.

Answer. An adequate answer to these questions would require a tremendous amount of special knowledge that I do not possess. I shall, therefore, offer general comments on only a few points.

Government activity has grown to huge proportions. Referring to 1950, Solomon Fabricant wrote, "One out of every eight persons employed in the United States today is a Government worker. One out of every five dollars of the Nation's capital assets—even excluding public roads and streets and most military and naval equipment—is Government property. One out of every twenty dollars of the consolidated net sales of business is made to Government." [4] In 1957 total expenditures of Federal, State, and local governments amounted to $115 billion.

With Government operations of such magnitude, the receipts and expenditures of Government assume importance of the first order. Waste in Government significantly reduces the standard of living. A

[4] The Trend of Government Activity in the United States Since 1900, p. 3.—National Bureau of Economic Research, Inc., New York, 1952.

major change in tax rates or in expenditures can dominate and determine the course of business activity. Built-in stabilizers, such as pay-as-you-go taxes, unemployment insurance, farm payments, and old-age and survivors' insurance become powerful defenses against cyclical instability. The distribution of the tax burden influences consumption and investments, and affects significantly the rate of economic growth.

The postwar record, except for the Korean war, indicates that the balance of Government receipts and expenditures has tended to shift from time to time so as to counteract cyclical movements and promote economic stability. This has resulted mostly from the operation of built-in stabilizers, but partly also from tax cuts in 1949 and 1954.

The opinion is widely held, and I think rightly so, that the present distribution of the tax burden tends to weaken the incentives to work and to take business risks. In support of this position can be cited the extremely high marginal rates of the income tax, the high tax on corporate profits, and the double taxation of corporate profits, first to the corporation and then to the individual. The effects of these extremely high taxes are mitigated erratically by the lower rate on capital gains and by a considerable number of special arrangements permitting splitting of income, special deductions for depletion, conversion of income into capital gains, et cetera. Many of these special arrangements offer strong inducements to risk-taking and new business investment as opposed to the earnings of high-bracket personal income.

The high upper bracket rates on ordinary income and the special arrangements create serious inequities and distortions in business investment. It would be fairer and better for the economy to reduce the upper bracket rates substantially and thereby obviate the need for loopholes.

Question 9. Will you distinguish between fiscal policy (embracing expenditures, taxes, and debt) and monetary and credit policy and then relate them, one to the other. Please discuss these policies stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

Question 10. (*a*) Comment generally on the adequacy or inadequacy of the United States monetary system. (For the purposes of this question consider that the monetary system includes bank deposits and bank credits.) Also please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

(*b*) Comment briefly on the adequacy or inadequacy of the United States fiscal system.

Answer. My answers to these questions would, for the most part, conform to the principles that are generally accepted by economists. The points on which I have comments to make are incorporated in the answers to other questions.

Question 11. (*a*) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy?

Answer. At times in the thirties inflation and large-scale unemployment occurred side by side. In recent months a more unusual phenomenon has appeared—rising prices coupled with increasing unemployment.

Even though large-scale unemployment exists, prices may rise if there is a sudden increase in demand, such as occurred in 1936–37, or in 1939 at the outbreak of World War II. In the recovery from a depression, prices likewise tend to move upward in response to increased demand before a condition of full employment is achieved. Again, the cost of living may rise during a period of heavy unemployment if there is a crop failure or if Government acts to raise farm prices.

These phenomena are less alarming than the kind of wage, cost, and price increases sponsored by the NIRA in 1934–35 while mass unemployment prevailed in the country. And they are less alarming than the kind of cost-push inflation experienced in recent years, which has culminated in strong union pressures for wage increases in the face of mounting unemployment.

The present cost-push inflation during a deepening recession is the product of monopoly power possessed by the unions and, it must be added, exercised by them without much regard to the general welfare. Using this power, the unions have continued to push up wages faster than productivity, thus increasing production costs and supply prices.

See also answers to questions 1, 2, 4, and 6.

Question 11. (*b*) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?

Answer. Inflation is, per se, evil. It hurts the weak and the poor. It taxes the savings and the incomes of those who cannot protect themselves—small savers, old people, and widows and children living on fixed-dollar incomes, and school teachers and other public servants on relatively fixed salaries.

No one advocates rapid inflation, only a slow inflation of a few percent each year. But the effects of such inflation are cumulative and soon cause great hardship to those with dollar savings and fixed dollar incomes. Furthermore, there is no assurance that chronic inflation can be kept down to such a slow pace. As people recognize what is happening, they will turn to escalators and other protective devices that will quickly transmit and accelerate the effects of inflationary pressures.

If a choice really had to be made between the evil of slow inflation and the evil of mass unemployment, I would choose the former. But such a choice does not have to be made, and if it did, there is doubt whether the alternative of slow inflation would be open to us for very long.

Despite the imperfections in business competition, the pressures making for price decreases and against price increases are very strong. If dollar wage rates were kept from rising, there is no doubt that the commodity price level would fall and real wages would rise. If wage rates and fringe benefits can be kept from increasing more than 2 percent a year, the increase can be absorbed by increased productivity without price inflation.

A high average level of employment can be achieved without inflation by means of appropriate monetary and fiscal policies if we will: (1) Limit the monopoly powers of unions so that they will not be able to drive up wages faster than productivity, and (2) continue through the antitrust laws to require workable competition in business.

Question 12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy?

Answer. This is a difficult question, and I doubt that anyone can answer it with assurance.

We emerged from World War II with a total private debt lower than in 1929, although gross national product had doubled from 1929 to 1945. Since 1945 private debt has increased much more rapidly than national product, but it still bears a lower ratio to national product than it did in 1929. The rise has been particularly rapid postwar in installment debt and in mortgage debt of consumers.

It is clear that the increase in private debt relative to gross national product cannot continue for long without adverse consequences. It is not clear that the present level of private debt is a threat to the economic stability and vitality of the economy.

Mortgage debt and installment debt facilitate saving and investment in housing, automobiles, and other durable goods. Since in most of the postwar period we were catching up in the accumulation of durable goods, it is not surprising that large increases should have occurred in installment and in mortgage debt.

Increase of debt is a powerful force making for growth and expansion in good times. Liquidation of debt is a powerful force making for contraction and cumulative depression. The danger inherent in the debt structure depends on the ratio of income and asset value to debt that will obtain when a recession in business occurs. Obviously, this will depend on how severe the recession is.

If our economy is inherently more stable than it was 30 years ago (and I believe it is) and if the Federal Reserve System continues to follow anticyclical policies (as I am sure it will), the danger from collapse of the debt structure will be very much less than it was after the twenties. If, in addition, we would adopt temporary tax reduction to combat severe recession (as apparently we are not yet ready to do), the hazards from collapse of the private debt structure as it now exists would be negligible.

Question 13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy?

Answer. Public works should never be used as a major means of coping with depression. Public works take too long to start and too long to stop. Their pump-priming effects begin too late in the depression and continue too long into the ensuing recovery and boom. Moreover, public works undertaken as antidepression measures are less likely to meet proper standards of need, careful planning, and efficient administration. It is desirable to accelerate Government purchases and public works underway if such acceleration can be achieved within a reasonable timespan and without loss of efficiency, but the total possibilities of such acceleration will not add up to enough to provide an important antidote to depression.

Temporary tax reduction is far superior to public works as an antirecession measure. It can take effect quickly, it can be of such magnitude as to reverse any deflation, and it can be stopped quickly. It can be in the form of cancellation for a temporary period of some

portion, or all, of personal income taxes. One possibility would be the cancellation of all withheld taxes and the equivalent on income not subject to withholding. This would increase personal incomes by about $2½ billion or 10 percent per month and would end a depression quickly.

A permanent tax cut, together with tax reform, would be highly desirable in depression if, after the cut, a balance in the Federal budget could be foreseen in the ensuing recovery. Such is not the case now. Even with present tax rates, the expansion of military expenditures and the increases in other Government spending recently authorized will probably lead to a deficit in the years immediately ahead unless inflation swells the amount of tax receipts.

A temporary tax reduction should be kept separate from tax reform or permanent tax reduction. This is desirable in the interests of simplicity, avoidance of delays, and public understanding.

The main question, on which there is room for wide differences of opinion, is the timing of major antidepression moves. The reason for these differences of opinion is the dilemma of wage inflation or unemployment posed by the monopoly power of the unions. Any successful moves to end the recession will be the signal for intensified wage demands and accelerated wage inflation. In these circumstances many people oppose strong monetary or fiscal action, preferring less inflation even at the cost of more unemployment. Others make the opposite choice, preferring to end the recession even though it means an acceleration of wage inflation. This is a most unhappy choice, and it will stay with us until we come to grips with the excessive economic power of unions.

If it were not for the threat of wage inflation we could act boldly and safely to end this or any other recession in short order. It would be possible to put into effect a massive temporary tax cut (e. g., the elimination of withheld taxes) when unemployment (seasonally corrected) exceeded 7½ percent of the civilian labor force, reduce the tax cut by half after 3 months, and terminate it at some specified time within 12 months or when unemployment dropped to 5 percent, whichever occurred first. The trigger points for starting and stopping a temporary tax reduction cannot be set much, if any, lower than those indicated without risking serious inflationary effects from such action.

In the world-as-it-is I would recommend that the Federal Reserve System move all the way to ease credit and reduce interest rates and do so more rapidly than it has. Then I would recommend action on temporary tax reduction at the points indicated. These moves will aggravate wage inflation—but I suspect that the prelude to curing wage inflation is to have more of it.

Question 14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?

Answer. Deficit spending by the Federal Government since the end of World War II has not been an important factor contributing to or producing inflation. Over the entire postwar period (calendar years 1946–57) the Federal Government had a cash surplus of $11 billion. In only 1 year, 1953, was there a sizable cash deficit. The legislative budget would show a less favorable picture, but it is the

cash budget rather than the legislative budget that reflects the impact of Federal receipts and expenditures on the economy.

In special areas Government spending produced inflationary results, for example, payments in support of agricultural prices and concentrated expenditures for defense during the Korean war. On the whole, however, the cash surpluses of the Federal Government during the postwar period had a dampening effect on inflation.

The deficit financing of the Government that occurred during World War II did, however, have a major inflationary effect in the postwar period. The inflation of 1946–48 was primarily a reaction to the excess money and near money that was created by Government borrowing during the war. And the pegging of the Government bond market from 1945 until 1951 made it impossible to take effective monetary action to control inflation during that period.

Question 15. Can full employment goals be attained while maintaining a dollar that has relatively stable purchasing power?

Answer. Given existing institutions, I believe it is not possible to maintain a dollar of relatively stable purchasing power while attempting to attain full-employment goals. In my judgment the force of cost-push inflation, and in particular wage inflation, is so strong that prices will rise and the value of money will depreciate if we attempt to maintain a reasonably high level of employment.

On the other hand, if the power of unions is reduced so that they cannot drive up wages faster than productivity and if workable competition in business is maintained by vigorous antitrust action, it will be possible to maintain a stable dollar and achieve a high level of employment through appropriate monetary and fiscal action. There will be cyclical ups and downs in production, employment and prices, but these can be moderated so that we can have a fairly stable price level and a high level of production and employment.

See also answers to questions 1, 4, 6, 11, and 13.

Question 16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?

Answer. Escalator provisions in wage and other contracts are of two types: (1) Those providing for adjustments to compensate for changes in the price level, and (2) those providing other automatic increases, such as the "improvement factor" that was originally intended to approximate the trend of increase in productivity.

Price escalators tend to speed up the transmission of inflationary or deflationary influences to buyers and employers. Unless they make excessive adjustments to compensate for price changes, price escalators do not initiate inflationary or deflationary movements. They only accelerate the spread of such influences throughout the economy, but this acceleration results in greater inflation or deflation than otherwise would occur in the economy.

"Improvement factors" that are limited to 2 percent or even perhaps 2½ percent per annum would not be seriously inflationary if all union demands, including wage increases and fringe benefits, could be contained within this 2 to 2½ percent. In actual practice, the cost of living and "improvement factor" escalators tend to become the base on top of which other demands are piled and from which the bargaining starts.

As a consequence, cost of living and improvement factor "escalators" play a most important role in wage inflation.

Unless and until unions are willing to accept cost of living and "improvement factor" escalation as the total amount available to cover all their demands—unless their other demands are substitutes for and not in addition to such escalation—the escalator provisions will lead to wage inflation and will be incompatible with the achievement of economic stability.

Question 17. List and briefly discuss what you consider the causes of the present recession, and what should be done to terminate it.

Answer. Among the causes of the present recession might be listed:

(1) Completion of "catching up" in the accumulation of producer durable goods and consumer durable goods to make up the shortages inherited from depression and war.

(2) Wage inflation: Wages driven up faster than productivity, leading to higher costs, higher prices and a reduction in profit margins.

(3) The actions of the Federal Reserve System to restrict credit in order to check inflation and moderate the boom.

(4) The failure of the Federal Reserve System to shift quickly enough and far enough from restrictive to expansionary measures.

(5) The reduction in inventories in response to reduced demand. The shift from inventory accumulation to inventory reduction accounted for two-thirds of the decline in gross national product from the third quarter of 1957 to the first quarter of 1958.

(6) The reduction in expenditures for consumer durable goods, especially automobiles, induced by the recession.

(7) The reduction in expenditures for producers' durable equipment induced by the recession.

Important steps have already been taken by the Federal Reserve System to ease credit and increase the money supply. Interest rates on bank loans and long-term borrowings are, however, still considerably above the levels prevailing prior to 1955. In my opinion further steps are needed to increase the money supply and exert additional downward pressure on interest rates.

The recession could be ended quickly by a large-scale temporary tax cut such as was described earlier. Whether such action should be taken depends on value judgments in regard to unemployment versus inflation. If such action is not taken there will be less inflation and more unemployment; if it is taken there will be less unemployment and more inflation.

A permanent tax cut should not be made at this time because of the prospective increase in Government expenditures. The yield from all our present taxes will be needed to balance the budget next year and the year after at high employment. The present 10 percent excise tax on automobiles is, however, so discriminatory and repressive that it should be reduced immediately to no more than 5 percent and the base of the excise broadened to other commodities as of January 1, 1959, to compensate for the loss of revenue.

What is needed most is a reduction in the monopoly power of labor so that monetary and fiscal actions can be taken without fear of cost-push inflation. Wage inflation is the key economic problem of this country. Solving that problem will make possible high employment, price stability, and dynamic economic progress. The resulting benefits to union members will far outweigh any possible gains they might achieve by exercise of union monopoly power.

See also answers to questions 2, 3, 5, 6, 11, 13, and 15.

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